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ABSTRACT

Oversight hearings on the Student Loan Marketing Association (Sallie Mae) are presented. Sallie Mae was established by the Education Amendments of 1972 to provide liquidity for Guaranteed Student Loan (GSL) lenders by purchasing GSL portfolios from lenders or making loans on GSL loans held by lenders. In 1982, Sallie Mae had total cumulative interest earning assets in excess of $5 billion. Currently, the Association also consolidates student loans, serving as a direct lender in areas where there are inadequate loans available from commercial lenders. Attention is directed, in the course of the hearings, to the Association's operations, its financial structure, its status in the private sector, and its future operating plans. Details are provided on its growth and assets, earnings, and dividends. Attention is also directed to new authorities of Sallie Mae, including the bankruptcy priority, the consolidation authority, the purchase of a savings and loan company, the question of whether it is subject to state taxation, and other state-related concerns. It is noted that the Association is both a quasi-governmental private corporation that has corporate responsibilities to its shareholders, and, on the other hand, a public purpose or a public responsibility to insure GSL access to students. (SW)

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OVERSIGHT HEARING ON STUDENT LOAN MARKETING ASSOCIATIONS

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HEARING

BEFORE THE

SUBCOMMITTEE ON POSTSECONDARY EDUCATION

OF THE

COMMITTEE ON EDUCATION AND LABOR
HOUSE OF REPRESENTATIVES

NINETY-EIGHTH CONGRESS

FIRST SESSION

HEARING HELD IN WASHINGTON, D.C.
ON MAY 24, 1983

Printed for the use of the Committee on Education and Labor

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OVERSIGHT HEARING ON STUDENT LOAN MARKETING ASSOCIATIONS

TUESDAY, MAY 24, 1983

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON POSTSECONDARY EDUCATION,
COMMITTEE ON EDUCATION AND LABOR,
Washington, D.C.

The subcommittee met, pursuant to call, at 9:36 a.m., in room 2257, Rayburn House Office Building, Hon. Paul Simon (chairman of the subcommittee) presiding.

Members present: Representatives Simon, Kogovsek, Ackerman, Erlenborn, Coleman, Gunderson, Petri, and Packard.

Staff present: Maryln McAdam, legislative assistant; Betsy Brand, legislative associate; and John Dean, minority assistant counsel.

Mr. SIMON. The Subcommittee on Postsecondary Education will begin its hearings. Today the Subcommittee on Postsecondary conducts an oversight hearing on the Student Loan Marketing Associations, Sallie Mae.

Sallie Mae was established in 1972 by the Education Amendments of 1972 to provide liquidity for guaranteed student loan lenders. It was to accomplish this function in one of two ways: The purchase of GSL portfolios from lenders or making loans on GSL loans held by lenders.

Sallie Mae has been an extremely successful association, with 1982 total cumulative interest earning assets in excess of $5 billion.

The functions of the association have grown from purchase of loans and warehousing lending on existing loans, to consolidation of student loans, serving as a direct lender in areas where there are inadequate loans available from commercial lenders, buying, selling, and underwriting and otherwise dealing in obligations issued by State agencies or eligible lenders.

The purpose of today's hearing is to gain a better understanding of how Sallie Mae operates—its financial structure, its status in the private sector and its future operating plans. In order to help us gain these types of insights we have invited a group of witnesses who have a wide range of experiences in the various aspects of Sallie Mae's operations.

Our first witness is Mr. Edward Fox, president of Sallie Mae. Mr. Fox is no stranger to this subcommittee, having testified on several previous occasions. Today he will be giving us an overview of the association's operating procedures, the programs it offers, pending

issues of concern to Sallie Mae, as well as its plans for future expansion and activities.

Accompanying Mr. Fox is Mr. Edward McCabe, the Chairman of the Board of Directors for Sallie Mae. Also testifying today is Mr. William Clohan, Jr., the general counsel of the Association of Independent Colleges and Schools.

This association has expressed a general concern that some of Sallie Mae's secondary market policies may be adversely affecting the ability of these students to obtain guaranteed student loans.

We are also pleased to have with us Mr. Frederick Hammer, executive vice president of Chase Manhattan Bank, the largest lender using Sallie Mae; and Mr. Peter Solomon and Mr. Geoffrey Hurley, an underwriter and bond counsel who are both familiar with Sallie Mae and its viability in the private market.

Let me add one other factor here and that there is a time factor that we are being pushed by, and we are going to have to move fairly rapidly, and I hope we can develop some kind of a consensus on what should be in the bill, and then be able to move.

We are happy to have as our first witness, Mr. Francis X. Cavanaugh, the Secretary of the Federal Financing Bank. When Sallie Mae was created, it was given the authority to borrow under the Federal Financing Bank. Mr. Cavanaugh will be presenting testimony on how the authority works and on Sallie Mae's current borrowing status under the Bank.

We are pleased to have you with us, Mr. Cavanaugh.

STATEMENT OF FRANCIS X. CAVANAUGH, SECRETARY OF THE FEDERAL FINANCING BANK

Mr. CAVANAUGH. Thank you, Mr. Chairman. I am here today to discuss the financial relationship between the Federal Financing Bank and the Student Loan Marketing Association.

My prepared statement will deal with the four specific issues that you asked me to address re Sallie Mae's original authority to borrow from FFB, the current status of that authority, the amount of borrowing and the repayment terms.

Sallie Mae was established in 1972 by an amendment to the Higher Education Act of 1965, as a for-profit Government-sponsored agency to provide liquidity for private originators of loans made under the Federal guaranteed student loan program and the health education assistance program.

The 1972 act authorizes Sallie Mae to issue obligations, with the approval of the Secretary of the Treasury, and it authorizes the Secretary of Education to guarantee principal and interest payments on those obligations.

When it passed the act, Congress intended that Sallie Mae eventually become a self-supporting private entity, and the act authorized Federal guarantees for Sallie Mae operations for only a limited time. Under the 1980 amendments to the act, the Secretary of Education may not guarantee Sallie Mae obligations issued on or after October 1, 1984.

Sallie Mae issued fully guaranteed obligations in the market until June, 1974, at which time it began borrowing exclusively from FFB. The FFB itself was established under the Federal Fi-

nancing Bank Act, which was enacted in December 1973 at the request of the Treasury to deal with the severe debt management problems resulting from the proliferation in the securities markets of a wide variety of relatively inefficient debt issues to finance the programs of a number of Federal agencies. FFB began operations in May 1974, and Sallie Mae was one of its first customers.

The FFB Act authorizes FFB to purchase any obligation that is issued sold or guaranteed by a Federal agency. Since Sallie Mae was established as a Government-sponsored corporation, and not as a Federal agency, FFB has purchased Sallie Mae obligations only because they are guaranteed by the Secretary of Education.

Sallie Mae now has $5 billion of long-term variable interest rate obligations outstanding with FFB. The Sallie Mae notes listed in the table attached to my statement had original maturities of up to 15 years and bear interest at rates which change each week, based on the results of each weekly auction of 13-week Treasury bills, plus the FFB's standard one-eighth of 1 percentage point.

Loans made by FFB generally are at interest rates which reflect the current cost of Treasury market borrowing plus one-eighth of 1 percent. Since FFB obtains its funds by borrowing from the Treasury at the Treasury's current borrowing rate, FFB's lending rate is generally one-eighth of 1 percent above its borrowing rate.

The interest rate paid by Sallie Mae to FFB has been around 8½ percent over the past month. The most recent FFB loan to Sallie Mae was made on January 7, 1982, when Sallie Mae borrowed the last of the funds available under a FFB commitment dated March 9, 1981.

The March 1981 commitment agreement between Sallie Mae and FFB was designed to eliminate dependence of Sallie Mae on the Federal guarantee and on FFB funding, and to facilitate Sallie Mae's entry into the private capital markets as an unguaranteed borrower—a long-held Sallie Mae goal.

The commitment agreement, which expired on September 30, 1982, permitted Sallie Mae to issue up to $5 billion of guaranteed obligations to FFB, inclusive of $3.3 billion of Sallie Mae notes that were already in the FFB portfolio.

The $1.7 billion of additional borrowing available to Sallie Mae under commitment was exhausted on January 7, 1982. Thus, Sallie Mae was able to issue unguaranteed debt instruments in the market and familiarize market participants with its program, while having the assurance of continued availability of FFB funds for a transition period.

Sallie Mae has borrowed only in the market since January 1982. While Sallie Mae obligations remain eligible for guarantee under current statute, the use of guarantees, and FFB financing, have not been necessary to meet Sallie Mae's financing needs.

We believe that Sallie Mae has made a successful transition into the market as an unguaranteed borrower and that further Federal loans and guarantees will not be needed.

Sallie Mae is still required to obtain Treasury approval of its market borrowing under the 1972 act. That approval requirement, however, is related to Treasury's overall responsibility for assuring that Federal and federally-related borrowing is done in the least disruptive way. It is a traffic cop function that is aimed at organiz-

ing the new issue calendar for debt issues of all federally sponsored agencies for their mutual benefit.

I would like to emphasize in closing that FFB relies only on the guarantee by the Secretary of Education for timely payment of principal and interest on Sallie Mae obligations.

FFB is no different in this respect from any other investor that holds a Government-guaranteed issue. In this connection, legislation was enacted in 1981 as an amendment to the Higher Education Act of 1965 to negate the United States priority claim on assets of Sallie Mae in the event of default on obligations issued on or before September 30, 1982.

That legislation was extended by a subsequent 1982 amendment to apply to obligations issued on or before September 30, 1984 and it has the effect of putting the U.S. claim on a parity with claims of other Sallie Mae creditors. That legislation does not affect the FFB since FFB would look to the Secretary of Education for payment in the event of default.

This concludes my prepared statement, Mr. Chairman. I will be happy to respond to any questions that you may have.

Mr. SIMON. Thank you very much. First of all, you are the first person the first live body, I have ever seen from FFB. [Laughter.]

In all of these years of referring to your agency, I have never known that there was anyone other than some robot down there handling all of this.

We are obviously interested in assistance to students. Your function is a somewhat different function. As you view our function and as you look at your recommendation, is there a conflict, do you feel, between your recommendation and our aim?

Mr. CAVANAUGH. No, I don't think so, Mr. Chairman. To the extent that we are recommending anything here, we are basically endorsing what has been done with respect to Sallie Mae going into the private market and raising funds to provide a secondary source of financing for students, and it has worked well, in my opinion. They have made the transition to an independent borrower in the market and are performing their role, I believe, very effectively. I think they provide the support that you need for the underlying guaranteed student loan program.

Mr. SIMON. In terms of interest, what kind of an increment does that mean, do you think, when you move from FFB to the private market?

Mr. CAVANAUGH. The increment varies from time to time, depending upon market conditions and the volume of issues by the Treasury and the agency, so it is hard to generalize about. Sallie Mae's most recent long-term issue, I believe, was a 10-year note earlier this month that went at a spread about 30 basis points above what the Treasury would have paid.

The Federal Financing Bank charges, on its lending to all borrowers, about one-eighth of 1 percent above the Treasury rate. So, if the Treasury—we're making up numbers now—were borrowing at 10 percent when Sallie Mae went to market at 10.30, FFB would have been lending at 10⅛ or 10.12, at that time. So those spreads, while significant in terms of Treasury financing, are relatively small amounts when you are talking about the cost of financing student loans or consumer borrowing generally.

Mr. SIMON. Mr. Petri.

Mr. PETRI. I would like to thank Mr. Cavanaugh for coming up and testifying. One question that I might ask may be one of the "iffy" questions people don t like to ask because the situation certainly is far from that, but it is whether the Federal Financing Bank cancels debts or renegotiates them or what those conditions are. I know we have a very healthy operation here right now and one that's, in fact, making some money, but that could change and I am just curious if that would require legislation or if the Federal Financing Bank could renegotiate.

Mr. CAVANAUGH. Renegotiate loans that it has outstanding to the various federal agencies?

Mr. PETRI. Yes.

Mr. CAVANAUGH. Yes, like any loan, an FFB loan is open to renegotiation if both parties to the loan agree, and the Financing Bank has been flexible with respect to all of its many agency borrowers. Essentially, it has been a matter of when borrowers want to pay off earlier than they expected or change the maturity of a loan.

The key factor that you may be getting at with respect to the interest rate is subject to very little flexibility as an operating matter. Under the FFB Act of 1973, we have considerable flexibility except that there is a mandate from the Congress there that we operate on a self-supporting basis. The Federal Financing Bank gets its money from the Treasury and turns around and lends to the agencies using the Bank at just one-eighth of 1 percent more. It's very important to us to stick to that and not renegotiate interest rates. Generally, the question doesn't come up because the Financing Bank, unlike commercial banks, is really not taking credit risks. Everything that we purchase, the whole $128 billion of assets, is in the category of issues sold or guaranteed by some other Federal agency.

We are basically a debt management consolidation technique. So we are not renegotiating loans in any commercial sense. We are not at risk.

Mr. PETRI. It's an administrative convenience for all the different agencies to have this central service.

Mr. CAVANAUGH. Yes, it's a debt management tool to lower the total cost to Government of all agency financing.

Mr. PETRI. Yes. Thank you.

Mr. SIMON. Mr. Packard.

Mr. PACKARD. I have no questions, Mr. Chairman.

Mr. SIMON. One final question. In your present relationship with Sallie Mae—has it been a difficult relationship at all? I don't mean just personalities, but in working things out.

Mr. CAVANAUGH. It's been a very happy, cooperative relationship right from the outset, both in terms of the organizational problems and the personalities as well. Sallie Mae, of course, was a model example, I think, for many of these Government-sponsored agencies that Congress has created with the intention that someday they go private. Sallie Mae has made that transition very effectively since that arrangement was worked out with the new administration in early 1981.

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And our other relationship, as I mentioned, apart from the FFB, is that by law, the Secretary of the Treasury is required to approve Sallie Mae issues in the market. That's handled by my staff as well, and that relationship has been excellent.

We have no problems, sir.

Mr. SIMON. Is there any reason why Sallie Mae, more than other agencies that borrow from the FFB, ought to be going into the private market?

Mr. CAVANAUGH. Well, I think they are basically in very sound financial shape compared to some of the agencies, in part, because of the way they manage their assets and liabilities—I think that's a very large factor. They are dealing in federally guaranteed student loans, which puts them into a pretty secure position with respect to their assets. So, with their assets being guaranteed by the Government and their liabilities being managed effectively in the market, they are much more able to borrow in the market on their own than perhaps some of the other agencies.

Mr. SIMON. We thank you very, very much for your testimony.

Mr. CAVANAUGH. Thank you, Mr. Chairman.

Mr. SIMON. Our next witness is Ed Fox, president of SLMA, accompanied by Edward McCabe, the chairman of the Student Loan Marketing Association Board of Directors.

We are pleased to have both of you here.

[Prepared statements of Francis Cavanaugh, Edward Fox, and Edward McCabe follow:]

PREPARED STATEMENT OF FRANCIS X. CAVANAUGH, SECRETARY OF THE FEDERAL FINANCING BANK

Mr. Chairman and Members of the Subcommittee: I am here today to discuss the financial relationship between the Federal Financing Bank (FFB) and the Student Loan Marketing Association (SLMA).

My prepared statement will deal with the four specific issues you asked me to address regarding (1) SLMA's original authority to borrow from FFB, (2) the current status of that authority, (3) the amount of borrowings, and (4) the repayment terms.

SLMA was established in 1972 by an amendment to the Higher Education Act of 1965 (the Act) (20 USC 1087-2), as a for profit Government-sponsored agency to provide liquidity for private originators of loans made under the Federal Guaranteed Student Loan program and the Health Education Assistance Loan program.

The 1972 Act authorizes SLMA to issue obligations, with the approval of the Secretary of the Treasury, and it authorizes the Secretary of Education to guarantee principal and interest payments on those obligations. When it passed the Act, Congress intended that SLMA eventually become a self-supporting private entity, and the Act authorized Federal guarantees of SLMA obligations only for a limited time. Under the 1980 amendments to the Act, the Secretary of Education may not guarantee SLMA obligations issued on or after October 1, 1984.

SLMA issued fully guaranteed obligations in the market until June 1974, at which time it began borrowing exclusively from FFB. The FFB itself was established under the Federal Financing Bank Act (12 USC 2281, et seq.), which was enacted in December 1973 at the request of the Treasury to deal with the severe debt management problems resulting from the proliferation in the securities markets of a wide variety of relatively inefficient debt issues to finance the programs of a number of Federal agencies. FFB began operations in May 1974, and SLMA was one of its first customers.

The FFB Act authorizes FFB to purchase any obligation that is "issued, sold, or guaranteed by a Federal agency." Since SLMA was established as a Government-sponsored corporation, and not as a Federal agency, FFB has purchased SLMA obligations only because they are guaranteed by the Secretary of Education.

SLMA now has $5 billion of long-term variable interest rate obligations outstanding with FFB. The SLMA notes, listed in the table attached to my statement, had original maturities of up to 15 years and bear interest at rates, which change each

week, based on the results of each weekly auction of 13-week Treasury bills, plus the FFB's standard ⅛ of 1 percentage point. Loans made by FFB generally are at interest rates which reflect the current cost of Treasury market borrowing plus ⅛ of one percent. Since FFB obtains its funds by borrowing from the Treasury at the Treasury's current borrowing rate, FFB's lending rate is generally ⅛ of one percent above its borrowing rate.

The interest rate paid by SLMA to FFB has been around 8½ percent (bond equivalent) over the past month. The most recent FFB loan to SLMA was made on January 7, 1982, when SLMA borrowed the last of the funds available under an FFB commitment dated March 9, 1981.

The March 1981 commitment agreement between SLMA and FFB was designed to eliminate the dependence of SLMA on the Federal guarantee, and on FFB funding, and to facilitate SLMA's entry into the private capital markets as an unguaranteed borrower—a long-held SLMA goal. The commitment agreement, which expired on September 30, 1982, permitted SLMA to issue up to $5 billion of guaranteed obligations to FFB, inclusive of $3.3 billion of SLMA notes that were already in the FFB portfolio. The $1.7 billion of additional borrowing available to SLMA under the commitment was exhausted on January 7, 1982. Thus, SLMA was able to issue unguaranteed debt instruments in the market and familiarize market participants with its program, while having the assurance of continued availability of FFB funds for a transition period.

SLMA has borrowed only in the market since January 1982. While SLMA obligations remain eligible for a guarantee under current statute, the use of guarantees, and FFB financing, have not been necessary to meet SLMA's financing needs. We believe that SLMA has made a successful transition into the market as an unguaranteed borrower and that further Federal loans or guarantees will not be needed.

SLMA is still required to obtain Treasury approval of its market borrowing under the 1972 Act. That approval requirement, however, is related to Treasury's overall responsibility for assuring that Federal and federally-related borrowing is done in the least disruptive way. It is a "traffic cop" function that is aimed at organizing the new issue calendar for debt issues of all federally-sponsored agencies for their mutual benefit.

I would like to emphasize in closing that FFB relies only on the guarantee by the Secretary of Education for timely payment of principal and interest on SLMA obligations. FFB is no different in this respect from any other investor that holds a Government guaranteed issue. In this connection, legislation was enacted in 1981, as an amendment to the Higher Education Act of 1965, to negate the U.S. priority claim (31 USC 3713) on assets of SLMA in the event of default on obligations issued on or before September 30, 1982. That legislation was extended by a subsequent 1982 amendment to apply obligations issued on or before September 30, 1984, and it has the effect of putting the U.S. claim on a parity with claims of other SLMA creditors. That legislation does not affect the FFB, since FFB would look to the Secretary of Education for payment in the event of default.

This concludes my prepared statement. I will be happy to respond to any questions you may have.

SLMA PROMISSORY NOTES

[In millions of dollars]

Note No.	Date of issue	Amount	Maturity	Interest payable
277	Nov. 18, 1980	2,000	Nov. 14, 1995	Weekly.
285	Dec. 30, 1980	650	Dec. 26, 1995	Do.
288	Jan. 13, 1981	350	Jan. 9, 1996	Do.
301	Mar. 31, 1981	100	Mar. 29, 1996	Semiannually.
303	Apr. 7, 1981	200	Apr. 5, 1996	Do.
306	Apr. 21, 1981	100	Apr. 19, 1996	Do.
314	July 1, 1981	300	July 1, 1996	Do.
315	July 16, 1981	100	July 16, 1996	Do.
316	Aug. 5, 1981	100	Aug. 5, 1996	Do.
317	Aug. 14, 1981	100	Aug. 14, 1996	Do.
318	Aug. 27, 1981	100	Aug. 27, 1996	Do.
319	Sept. 16, 1981	100	Sept. 16, 1996	Do.

SLMA PROMISSORY NOTES—Continued

[In millions of dollars]

Note No.	Date of issue	Amount	Maturity	Interest payable
320	Sept. 23, 1981	100	Sept. 29, 1996	Do.
321	Oct. 1, 1981	300	Oct. 1, 1995 [1]	Do.
322	Jan. 7, 1982	400	Jan. 7, 1997	Do.

[1] 10 equal annual installments of principal beginning on Oct. 1, 1986.

Source: Federal Financing Bank, May 19, 1983.

PREPARED STATEMENT OF EDWARD A. FOX, PRESIDENT AND CHIEF EXECUTIVE OFFICER, STUDENT LOAN MARKETING ASSOCIATION (SALLIE MAE)

The Student Loan Marketing Association (Sallie Mae) is a private, for-profit corporation chartered by Congress to provide a national secondary market for insured student loans made by private or state lenders under the federally-sponsored Guaranteed Student Loan Program (GSLP) and Health Education Assistance Loan Program (HEAL).

By Congressional intent, Sallie Mae is structured along traditional corporate lines, with total responsibilities in the hands of a board of directors and a management team. The President of the United States appoints one-third of the 21-member board and designates the chairman from among the full membership. By statute, financial and educational institutions are permitted to own shares of voting stock of the corporation and each group elects one-third of the board of directors.

Sallie Mae provides a broad spectrum of private and state lenders—commercial banks, thrift institutions, credit unions, educational institutions, state agencies and other lenders—with a source of liquidity. It offers such lenders the opportunity to sell student loans at cash value or to borrow additional funds to support their student lending activity by pledging existing loans as collateral, thus serving as a secondary market for student loans.

In 1980, amendments to the basic enabling legislation, the Higher Education Act of 1965, enlarged Sallie Mae's statutory program and financing authority. Specific provisions authorize the corporation to consolidate or refinance student loans, to lend funds directly to state agencies where there is a certified shortage of loan capital, and to serve as a direct lender in states where there is a severe student loan shortage. Various amendments were included in the Omnibus Budget Reconciliation Act of 1981 broadening Sallie Mae's authorities as a prospective "safety net" in support of student credit.

In 10 years of operation, Sallie Mae has provided more than $9.2 billion of support to lenders under the GSLP. As of April 30, 1983, its direct investment of $6.5 billion in the GSLP in addition to outstanding commitments was equal to approximately 30 percent of all insured student loans outstanding. This compares favorably with the experience of all government-sponsored housing secondary market activities combined which have ranged between 15 and 24 percent during the past five years.

Sallie Mae has worked with 1,700 lenders providing direct or indirect financial assistance to millions of students in 51 states and territories. It has assisted in financing statewide programs in 18 states and the District of Columbia.

Sallie Mae obtains funds for its operations primarily from the sale of its debt obligations. In the past it financed its activities principally through the issuance to the Federal Financing Bank (FFB) of debt obligations guaranteed by the Secretary of Education. As announced by Secretary Regan on May 7, 1981, Sallie Mae has begun borrowing in the public markets without the guarantee of the federal government.

The corporation is expected to meet the same profit and loss standards, including a return on stockholders' equity, as a business without a government link. It pays full federal income taxes and has received no federal appropriations during its entire history. Sallie Mae has severed its ties with the federal government in connection with its funding activities. Its objective is to achieve its primary social purpose of expanding credit in support of access to postsecondary education by operating as a business organization subject to the disciplines and opportunities of the marketplace. As such, Sallie Mae considers itself to be a prototype for transforming a quasi-government organization into a private sector corporation that functions efficiently and profitably while fulfilling its original public service purpose.

SALLIE MAE PROGRAMMATIC SUPPORT FOR STUDENT CREDIT

Sallie Mae, as the national secondary market for student loans, has attempted to provide support for all sectors either by traditional secondary market programs or specialized programs designed to address a particular need to provide student credit.

TRADITIONAL SECONDARY MARKET PROGRAMS

An examination of Sallie Mae's program activities under its Loan Sale, Warehousing Advance, and Commitment Programs reveals the extent of the corporation's support of the GSLP and the national objectives set forth by the Congress. Under its enabling legislation, Sallie Mae is authorized, pursuant to commitments or otherwise, to make advances on the security of, purchase or repurchase, service, sell or resell, offer participations or pooled interests, or otherwise deal in federally insured student loans or student loans that are insured by state or private guarantors participating in the GSLP. In 1981 Sallie Mae was authorized to provide similar secondary market services for non-insured student loans. The corporation is prohibited from dealing with institutions that discriminate on the basis of race, sex, color, creed or national origin and from dealing with any commercial bank with deposits in excess of $75 million, which requires a customer relationship with the student or his or her family as a condition to receiving a student loan.

Under its Loan Sale Program, Sallie Mae offers to purchase loans made under the GSL and HEAL Programs. The Loan Sale Program provides funds to lenders and, because the corporation utilizes a network of third-party servicing agents, relieves those lenders of the administrative considerations relative to loan servicing. Through its Warehousing Advance Program, Sallie Mae provides liquidity to lenders against the collateral of their existing student loan portfolios of other U.S. Government issued or guaranteed obligations. By statute, institutions with advances collateralized by insured student loans must either reinvest all advance proceeds into additional guaranteed student loans or maintain a specified student loan portfolio level throughout the term of the advance. Institutions offering other collateral must fully reinvest all advance proceeds. Sallie Mae also provides the assurance of future funds through the issuance of forward commitments. These commitments, for both the Loan Sale and Warehousing Advance Programs, have enabled many state and private lenders to maintain lending arrangements through the assurance of continued student loan credit.

SPECIALIZED PROGRAMS

Community Lender Sale Program

In 1981 Sallie Mae developed the Community Lender Sale Program specifically to meet the student loan funding needs of the smaller institutions. Since the inception of this program, Sallie Mae has negotiated over $44 million in loan sales with close to 200 institutions, each with assets less than $100 million. Over 59 percent of the Community Lender Sale Program dollar volume has been negotiated with lenders during the first four months of 1983.

Money Market Advance Program

The Money Market Advance Program was created in 1982 to augment our traditional, variable-rate advance program. Under this program Sallie Mae executes a master note with the borrower with the terms ranging from one to nine months. Sallie Mae has lent $200 million thorugh our Money Market Advance Program. This program enables Sallie Mae to transmit the cost savings realized through the issue of discount notes directly to the borrower.

HEAL Assured Access Program

During the past three years, Sallie Mae has provided a secondary market in support of the HEAL Program. Because of increased demand for HEAL loans in 1982 and reduced participation by the banking system, Sallie Mae has provided capital in support of a lender-of-last-resort program to assure that all qualified prospective borrowers are able to obtain a loan. This program was put in place following consultation and with the support of the Department of Health and Human Services, bankers, and the appropriate educational institutions. Through April, 1983, Sallie Mae had disbursed nearly $31 million under the Assured Access Program to 5,000 students atending institutions all over the United States. This represented approximately one-third of all HEAL loans originated during this period. We are also pleased to report that Sallie Mae currently has commitment agreements to pur-

chase HEAL loans from ten financial institutions. Offering these commitments has induced many of the lenders into the Program.

United Negro College Fund Assured Access Program

In 1982 Sallie Mae acted as the intermediary in setting up an arrangement between the United Negro College Fund (UNCF), Health Education Assistance Foundation (HEAF), and Citibank which would ensure the availability of funds for students attending the 42 UNCF member colleges. As of the end of April, over 5,100 applications had been approved and these applications totalled close to $10.5 million in GSL funds. This exceeds the $10 million goal agreed to by Citibank, HEAF and UNCF. Citibank has agreed to commit up to $20 million for UNCF students for the academic year 1983–1984.

Non-Insured Student Loans

As we informed this Committee, we have instituted a small pilot program of non-insured student loans. Sallie Mae recently agreed to establish a $3 million Line of Credit for First American Bank, N.A., of Washington, D.C. as back-up for providing a loan facility to nine educational institutions participating in the D.C. Higher Education Consortium. The loan facility will be be used to provide financing to parents of students (except freshmen) who are attending any one of the following Consortium schools: American University, Catholic University, George Washington University, Georgetown University, Howard University, University of the District of Columbia, Gallaudet College, Mount Vernon College and Trinity College. This transaction represent Sallie Mae's flexibility in providing new and expanded programs to both educational and financial institutions in its continued efforts to support the credit needs of students and their parents.

Loans to States

Although this authority was provided to Sallie Mae in the Education Amendments of 1980; the position of the Department of Education has prevented any activity under this program. This issue will be discussed at greater length below.

Loan Consolidation Program (Options)

Sallie Mae was given the responsibility in the 1980 amendments to put in place a Loan Consolidation Program for certain qualifying students relative to the National Direct Student Loan Program (NDSL) and the GSLP. Approval from the Department of Education was not forthcoming until late in 1981, resulting in a pilot program first being offered during the fourth quarter. Because of the lack of a usable data base to identify prospective candidates for loan consolidation, and due to an extremely time consuming and costly process of origination, results of our pilot program are just beginning to become available. A preliminary response from high indebtedness graduates suggests modest interest in the loan consolidation opportunity. However, Sallie Mae is committed to providing loan consolidation to all qualified students.

Other Authorities

Sallie Mae has additional authorities provided to it which have not been exercised. We hope in the near future to secure a ruling from the Internal Revenue Service which will allow Sallie Mae to purchase state issued student loan revenue bonds up to two percent of our assets, or approximately $160 million.

Sallie Mae has other authorities which have not been exercised because the need for such programs has not yet arisen. Sallie Mae will consult with this Committee and seek your guidance in any new initiatives, and will not implement any program inconsistent with Congressional intent.

SALLIE MAE PROGRAM SUPPORT

During 1982, Sallie Mae provided $2.0 billion of secondary market support for the GSLP, compared to $2.7 billion in 1981. This reflects in part the lower level of student loan originations during 1982 and cyclical changes in the economy. During the year the corporation's holdings of student loan related assets increased by 32.9 percent over the previous year. From December 31, 1977, through December 31, 1982, the corporation has grown nearly 14 fold from total assets of $560 million to slightly over $7.5 billion. Sallie Mae purchased $1.4 billion of guaranteed student loans in 1982, representing over 1,690 transactions from institutions in almost every state in the union. During 1983, Sallie Mae expects to increase its dollar volume of loan purchases against the 1982 performance. Warehousing advances (loans) extended in

1982 totaled approximately $700 million. Warehousing advances outstanding at year-end totaled $3.2 billion. Lowered interest rates suggests that demand for this service from Sallie Mae will diminish substantially in 1983. Additionally, Sallie Mae provided $760 million of commitments to 39 institutions in 1982 to either purchase loans or lend at a future point in time. As of April 30, 1983, such commitments, which are contingent liabilities of the corporation, totalled nearly $1.2 billion.

FINANCING OF SALLIE MAE

The most significant single development in the financial area during 1981 was the negotiation of an agreement with Administration officials in March that set the basic course of Sallie Mae's funding activities for the future. In exchange for an additional $2 billion of long-term financing authority at the FFB (bringing the total of such borrowing authority to $5 billion) the corporation agreed to accelerate the time schedule for re-entry into the capital markets to fund its activities. Specifically, the agreement called for Sallie Mae to end its borrowing from the FFB by September 30, 1982, or at the time a total of $5 billion of such borrowings was outstanding. Sallie Mae also agreed to enter the capital markets without the use of the full faith and credit guarantee of the Department of Education which was originally available until October 1, 1984. Working in concert with the Treasury Department, this agreement provided a sound base for Sallie Mae to begin financing its program acquisitions without federal support, as intended by Congress.

Sallie Mae raised $2 billion in 1982 and we are gratified that our innovation and expertise in capital formation enabled the corporation to meet its programmatic demands, albeit with the higher costs associated with fund raising in the private capital markets. This was accomplished without raising our prices to our customers. I am pleased that in 1983 we expect again to offer service without raising the cost of doing business to our constituency. In fact, during the past 18 months, we have actually lowered the cost of doing business with Sallie Mae to many customers as we have passed through the benefit of operating efficiencies. Our plans forecast that in order to support the $6.5 billion plus annual growth in the GSLP in the foreseeable future, Sallie Mae must be able to raise nearly $2 billion in each of the next three years. Given the increasing demands for capital throughout the world, a strong balance sheet and strong earnings statements are Sallie Mae's assurances that it will have access to capital in the quantity necessary and price appropriate to support student financial aid programs during the 1980's.

We are pleased to advise you that this year Sallie Mae sold $250 million of preferred stock to the public. The proceeds from this sale will greatly enhance the financial strength of the corporation. The issue was sold in competition with stock offerings made by many of the largest banks in the United States and was readily accepted in the marketplace. It is our belief that the success of this offering was largely the result of the strong balance sheet and the long-term earnings record of the corporation. Hopefully, sustained solid financial performance will continue to induce private capital to be invested in Sallie Mae for the continued support of postsecondary education.

In calendar year 1982, Sallie Mae earned $68,715,000. Of that amount, $30,962,000 was provided to pay the related federal income tax liability, $2,125,000 was paid to stockholders in the form of dividends, and $35,628,000 was added to retained earnings and was available for reinvestment in student loan assets. The corporate return on assets was .62 percent, or, stated another way, Sallie Mae earned 62 cents on each $100 of invested funds during 1982. This was a significant improvement over the .45 percent in 1980 and 1981 and reverses a downtrend that had begun in the late 1970's. Return on assets is a measure of financial health by which institutions are evaluated. Sallie Mae's return on assets during the past few years has been significantly below the median of large regional and money center financial institutions with whom we compete in the credit markets for capital. Income was enhanced by the dramatic increase of program assets in late 1981 and 1982, efficiencies in fund raising, and reduction of general and administrative costs per unit of business. Many of these efficiencies will not carry over to future years, particularly, as the corporation's loan portfolio matures and goes into repayment.

As an undercapitalized, highly leveraged financial institution, it has been the policy of the Board of Directors to direct the majority of our earnings back into the corporation and into its programs by building the capital account through retained earnings. Shareholders have been understanding of this need to retain earnings and for that reason have been willing to forego meaningful dividends as the corporation was growing. However, in order to continue to attract capital, Sallie Mae will ultimately have to act like other privately-owned, financial institutions in terms of its

payout. The corporation's debt-to-equity was 72:1 at year-end 1982, and it was the corporation's goal to reduce that ratio as quickly as possible through the two primary means available to us: retention of earnings and the sale of equity or subordinated securities. With the recent sale of the adjustable rate preferred stock issue, we have substantially reduced our debt-to-equity ratio, but it is still higher than many banks and most quasi-government entities with whom we compete for funds.

We are currently evaluating the feasibility of issuing a security in the form of a student loan pass-through or participation certificate. Also, we are examining the potential market and need for a common stock issue.

It is also possible that Sallie Mae will enter the Eurocredit markets in 1983 with a modest sized debt issue to introduce the corporation's name to that potentially valuable source of liquidity. Although such an issue is unlikely to be indexed to U.S. Treasury bills, it is expected that being prepared for proper market execution will enable the corporaton to tap this market at a propitious time and at a reasonable cost. Preliminary planning for this financing is already underway.

INTERRELATIONSHIP OF SALLIE MAE FINANCING, PRICING POLICY AND SERVICING

Sallie Mae's financing costs directly relate to the cost of Sallie Mae's programs to its customers.

In the investment analysis or pricing process, Sallie Mae estimates the net earnings of a student loan portfolio over its entire life by projecting the stream of cash flows which a given portfolio is expected to generate. Then, using net present value techniques, Sallie Mae discounts these cash flows to insure that expected earnings are sufficient to cover forecasted financing, servicing, and G&A costs, as well as to provide a planned return on assets. The relative amounts and specific net earnings of these flows vary from portfolio to portfolio as does the yield potential. One of the variables of major concern to Sallie Mae is its cost of funds. Like any prudent financial institution, Sallie Mae must insure a sufficient spread between the rates its assets earn and the rates it pays for its sources of funds. A second critical variablle is future servicing costs. While a student loan asset may be on the corporation's books for more than ten years, Sallie Mae has generally only been able to secure servicing contracts which extend one to three years. A third critical variable is General and Administrative Expense, or indirect operating costs. Sallie Mae has grown rapidly in response to the demands and needs of its customer base and hopefully will achieve enhanced productivity over time. Offsetting these savings will be higher expenses due to the increasing complexity of the GSLP, legislation and to the new products such as Parent Loan Undergraduate Studens (PLUS) and Auxiliary Loans to Aid Students (ALAS). The seller-influenced characteristics of most critical importance to the value and price of a portfolio are average indebtedness, average number of notes per borrower, average expected months remaining in status, percent of serial borrowing and student loan rates.

We would suggest that during the reauthorization process this Committee seriously examine the small loan problem. The costs associated with originating and servicing a small loan continue to plague the GSLP, from the perspective of schools, banks and Sallie Mae. This problem actually relates to most forms of consumer credit offered by financial institutions. The high costs associated with small balance loans have resulted in the raising of minimum indebtedness requirements throughout the banking and financial services industries. We should be able to reach a workable solution to these problems.

Servicing of student loans continues to represent a threat to the long-term viability of the GSLP. Adherance to current and prospective regulatory interpretations and law by those responsible for servicing requires constant attention to detail and a commitment of meaningful dollars. It is essential that all parties be aware of the risk that servicing represents to the entire student loan system. During 1982, Sallie Mae increased from 10 to 12 the number of contract servicers acting as agent to collect its loans. Through December 31, 1982, Sallie Mae was collecting on about $350 million of student loans at its own service center, or approximately 11 percent of the $3 billion of student loans owned. The corporation has developed its own software system at considerable expense and has that system fully tested and functioning enhancing its collection capability and efficiency. Student loan servicing continues to be plagued by a lack of commonality among the requirements of the various guarantors which results in a plethora of differing routines in the collection system for each state. Hopefully, some method will be developed for encouraging uniformity where differences are not truly warranted. The process is additionally impaired by the rigidity with which regulations are interpreted, often differing in each of the 10

federal regions. I would hope that the Congress takes note of the operational aspects of any proposed changes in the GSLP so that the intent of the change can be managed within the framework of the existing banking system.

Changes in the banking and financial services industry could have an impact on the GSLP. We anticipate continued movement towards interstate banking and a continuance of interstate and interindustry mergers. This trand is accompanied by continued expansion of financial services which require a considerable amount of systems and data processing support. We are not convinced that the financial services industry is willing to commit large dollar amounts or to give first priority for changes and development of student loan systems. Additionally, we are concerned about the willingness of the banking system to commit the dollars to the primary market in guaranteed student loans in the amount that current Office of Management and Budget (OMB) and Department of Education loan volume projections for the next five years imply. We are also aware of the banking system's lack of interest in the parent loan program, primarily because of the high costs associated with immediate collection, operational problems, the impact on other lending, and the probability of change.

CURRENT ISSUES

Federal Priority

We are appreciative of the support of the Congress in providing a technical amendment to Sallie Mae's enabling statue in 1982 which provided that "[t]he priority established in favor of the United States by Section 3466 of the Revised Statutes (31 U.S.C. 191) shall not establish a priority over the indebtedness of the Association issued or incurred on or before September 30, 1984." This amendment has created a temporary waiver as it is limited to debt issued or incurred prior to September 30, 1984. If this limitation is not removed before that date, Sallie Mae will find itself unable to finance its activities, to fund outstanding commitments, and to fulfill its Congressional mandate of providing liquidity to the student loan market.

We would point out that Sallie Mae's authority to ask for the full faith and credit guarantee of the federal government also expires on October 1, 1984. This would leave the corporation without any source of financing other than its line of credit to the Department of the Treasury. If that line of credit was ever exercised, the corporation's ability to ever enter the public credit markets would be in jeopardy. Essentially, the Federal Priority Amendment must be extended if Sallie Mae is to continue. We cannot, in dealing with the public credit markets, afford to erode the confidence which has been built over the past two years. To risk even a hiatus in funding activity in 1984 is to create potential dire consequences for the future existance of the corporation. We ask you to give serious consideration to extending the Federal Priority Amendment at the earliest opportunity.

Loans to States

As I indicated earlier, the 1980 amendments clarified Sallie Mae's ability to lend directly to states. The Department of Education has reviewed the statute and concluded that states borrowing from Sallie Mae on a direct basis would qualify for only a half special interest allowance. Many states have approaches Sallie Mae during difficult times in the student loan revenue bond markets, seeking financing from Sallie Mae. The interpretation given to Sallie Mae's authority, however, has prevented Sallie Mae from providing this assistance. Resolution of this issue is a critical necessity for the viability of programs in many state lending agencies.

Most state agencies have financed their GSL Programs with the sale of three-year tax-exempt revenue bonds. The acquired asset will have a life that is considerably longer. To the extent that refinancing is prohibitively expensive or that legislative change either limits or excludes the issuance of student loan revenue bonds, it is absolutely essential that alternative funding be available to the states. Using data from the Congressional Budget Office, the Joint Committee on Taxation, and the Department of Education, we have estimated that the use of a loans-to-states program would substantially reduce costs fo the Federal Government relative to the GSLP.

The Department of Education suggested that as an alternative, Sallie Mae might pursue becoming a direct lender in those states in which demand cannot be satisfied through a Loans to States Program. Sallie Mae would prefer to deal in wholesale rather than retail programs but, more importantly, with a strong existing structure of established state guarantee agencies, it would be inappropriate to by-pass or replicate these institutions in providing retail services in their states. We are gratified that the majority and minority leadership of the House and the Senate communicat-

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ed with the Secretary of Education that the Department's position was inconsistent with the intent of the original statute. It is our understanding that the Department of Education is supporting a technical amendment to the Statute which would allow states to receive full special allowances on loans made from funds advanced by us so long as we treat the income on such advances as taxable.

Disclosure Rules

I testified before this Subcommittee in February on the operational problems associated with the new student disclosure provisions enacted in the Student Financial Assistance Technical Amendments Act of 1982. I sincerely appreciate your efforts, Mr. Chairman, to help resolve this difficult operational issue. Implementing these provisions could cost Sallie Mae alone several million dollars, for little benefit to students.

We, of course, would look forward to working with the Subcommittee in working out appropriate solutions to the current problems. We wish to emphasize that we believe that useful and complete loan information can and should be disclosed to borrowers in a way that is readily comprehensible to them and that such disclosures can be made, both at the time of the origination of the loan and at the time of loan repayment, in a manner that can be accommodated by the automated servicing systems currently used in the GSL Program.

Acquisition of a Financial Institution

Mr. Chairman, we recently notified this Subcommittee and the Senate Subcommittee that the Sallie Mae Board of Directors voted to authorize corporate management to pursue an acquisition of a finance subsidiary.

The subsidiary financial institution would, of course, remain subject to the same statutory limitations placed on the parent corporation by Congress in Section 439 of the Higher Education Act.

The acquisition of a finance subsidiary by Sallie Mae would add operational capabilities not now available to the corporation and would greatly facilitate Sallie Mae's efforts to support the student credit market. As an example, Sallie Mae could begin to invest funds in state issued student loan revenue bonds, providing support for these bonds at all times. The acquisition would also afford Sallie Mae the opportunity to expand its servicing capacity and to utilize a new source of funds—customer deposits—in support of Sallie Mae programs. These activities, we believe, are desirable to support student credit and responsive to problems arising in the market.

The possible acquisition of a financial institution has been under examination for over a year. We have determined that acquisition of a small savings and loan association would be the most appropriate vehicle to accomplish Sallie Mae's purposes. Under the Garn-St Germain depository Institutions Act of 1982, such an institution may be converted from a mortgage based institution to a student credit institution. Following the acquisition, mortgage related assets, to the extent possible, would be liquidated at the earliest opportunity and replaced with student credit assets. The only activities not related to student loans which would be continued after an acquisition would be those incidental activities necessary to maintain the deposit base or required by regulatory authorities.

Mr. Chairman, simply put, Sallie Mae's acquisition of a financial intermediary—a financial institution—will expand our capacity to serve our customers and our social purpose. By utilizing the resources of an existing financial institution, Sallie Mae will buid a better base for delivery of products and service. We are continuing to discuss this acquisition with Congressional staff and will continue to do so.

Loan Consolidation

Mr. Chairman, as you are aware, Sallie Mae was authorized to provide a program of loan consolidation in the Education Amendments of 1980. We have successfully created and marketed OPTIONS to students for two years. As you are also aware, our authority to offer this program expires August 1, 1983. Due to the procedural complexities of loan consolidation, this will require that we begin notifying applicants on June 1, 1983, of the significance of this date. Applications not fully completed and returned in time for Sallie Mae to disburse prior to July 31, 1983, will not be processed further unless the enabling statute is reauthorized. Sallie Mae has expended over $2 million in creating the OPTIONS Program. We respectfully request that Sallie Mae's consolidation authority be extended.

I will be testifying before this Subcommittee on June 8 and I will at that time provide far greater detail as to the Sallie Mae OPTIONS Program and our concerns. However, I would like to make two points. First, loan consolidated and the process and

procedures by which a consolidated loan is created are extremely complex. Servicing of graduated repayment loans is also extremely complex. I cannot emphasize too strongly that the structure of any loan consolidation program is critical. The simple fact of consolidating a student's indebtedness is inherently so complex that the structure of the program should not add to the problems. We look forward to working with this Committee and we look forward to continuing to offer the OPTIONS Program.

Second, Mr. Chairman, as a businessman, I cannot endorse the concept of a monopoly. Your Subcommittee has the difficult responsibility of determining the policy implications of program costs to the Federal Government. Sallie Mae would like to continue to offer OPTIONS. We, however, leave to your judgment and that of the Subcommittee what other consolidation programs should be available and the costs to the Federal Government associated with these additions. However, Sallie Mae will neither request nor do we require a monopoly.

CONCLUSION

Mr. Chairman, Sallie Mae has recently celebrated its 10th anniversary. Sallie Mae's development indicates that the private sector can create and manage a vehicle to meet public service goals. Over $9.2 billion in support of student credit has been provided by Sallie Mae in its 10-year history. We look forward to continuing to support student credit through the private capital markets.

STUDENT LOAN MARKETING ASSOCIATION (SALLIE MAE)

A STATEMENT OF ITS PURPOSE, FUNCTION, AND OPERATING PROGRESS

Established by the 1972 Amendments to the Higher Education Act of 1965, the Student Loan Marketing Association (Sallie Mae) is a federally chartered, privately owned corporation.

"The Congress hereby declares that it is the purpose of this section to establish a private corporation which will be financed by private capital and which will serve as a secondary market and warehousing facility for student loans . . . and which will provide liquidity for student loan investments." [20 U.S.C. Sec. 1087-2 (a)]

Shareholder-owned and controlled, Sallie Mae was established to support the federal government's Guaranteed Student Loan Program (GSLP). The GSLP is a program of federal insurance or reinsurance for loans obtained by students from state or private sources. Under this program, students obtain credit primarily from private lenders with the government providing insurance against defaults as well as an interest subsidy to the borrower and a special allowance to the lender.

In 1976, the Health Professions Education Act established a program of federally insured loans to graduate health professions students, the Health Education Assistance Loan (HEAL) Program. The first HEAL loans were made in 1978. Sallie Mae is authorized to provide a secondary market for loans made under this Program.

In 1980 and 1981 Congress broadened Sallie Mae's program and borrowing authorities which, among other provisions authorizes the corporation to provide a program of loan consolidation to eligible borrowers, authority was vested in the Board of Directors of the corporation to approve other activities and programs deemed by the Board to be supportive of the federally insured loan programs and student credit needs generally.

Congress created Sallie Mae in a manner similar to other government sponsored corporations. The purpose of establishing a secondary market was to enhance the attractiveness of student loans to banks and other primary lenders, thereby generating more private capital for the student loan market. Sallie Mae was intended to provide lenders with a source of liquidity—a national, accessible secondary market where lenders could sell their student loans or borrow (warehouse) on the collateral of those loans. Program users were expected to provide the equity capital for the corporation and were expected to provide the equity capital for the corporation and additional funds were to be obtained through the sale of government guaranteed debt obligations. The corporation was to use these funds to purchase or warehouse student loans. In this way, Sallie Mae would support the Congressional objective of maximizing private capital participation in student loan financing, consistent with the assurance of loan access by borrowers. In meeting its responsibilities, Sallie Mae is subject to review not only by its Board of Directors, but also by the federal government and the Congress. This pattern of oversight requires Sallie Mae to balance its public and private interests to assure corporate financial objectives as well as program objectives in support of the GSLP and postsecondary credit generally. In addition to statutory oversight and review, Sallie Mae, in the conduct of its busi-

ness, must abide by regulations applicable to all holders of GSLP loans including those of the Secretary of Education and the state and private guarantee agencies.

Sallie Mae's status as a federally chartered, private corporation reflects two fundamental and complementary realizations by the Congress: First, that the public interest requires a viable and equitable system of student credit which will operate more effectively with the support of a national secondary market. Second, that a secondary market motivated by private sector objectives represents the least expensive and most efficient means of providing this support.

While Sallie Mae has neither requested nor received any appropriated funds, Congress did enable the corporation to borrow, through 1984, with the full faith and credit of the United States supporting its debt. In 1973 and 1974, Sallie Mae raised $400 million in the private debt markets as a new, untested corporation. From the establishment of the Federal Financing Bank (FFB) in 1974 through 1980, Sallie Mae borrowed exclusively from this source. The bank loaned to Sallie Mae at a rate higher than it paid for its funds, thus generating a profit for the FFB. Congressional intent behind the Bank was that those entities utilizing the full faith and credit of the United States should use the FFB in the interest of a more coordinated and cost efficient approach to financing.

In early 1981, Sallie Mae reached an agreement with the U.S. Treasury Department to limit its borrowing from the FFB and reenter the capital markets without use of the full faith and credit guarantee, by statute still available through September 1984. Under this agreement, the corporation was eligible to borrow up to $5 billion on a long-term, variable-rate basis through September 1982. The final borrowing under this agreement occurred in January 1982.

In anticipation of completing the FFB borrowing arrangement, Sallie Mae established a Discount Note Program in May 1981. These short-term securities provided the corporation with a vehicle by which it could introduce itself to the market while developing a reliable and flexible source of funds. The average balance of discount notes outstanding during the first quarter of 1983 was $350 million.

The transition to the private capital markets continued during 1982 and the first quarter of 1983 through the sale of short-and intermediate-term notes. The notes are non-guaranteed, unsecured obligations of Sallie Mae. In 1982 the corporation issued, in three separate transactions, floating-rate debt totalling $650 million. The corporation also executed two master note agreements totalling $100 million with maturities of lesser than one year. During the latter half of 1982 through March 31, 1983, the corporation issued a total of $1 billion in fixed-rate debt. The interest obligations in the fixed-rate debt were transformed into floating-rate obligations by entering into interest exchange agreements with independent parties to make periodic variable payments in exchange for periodic fixed payments.

On March 1, 1983, Sallie Mae issued $250 million of non-voting, adjustable-rate, cumulative preferred stock, which pays dividends that fluctuate with U.S. Treasury interest rates. The preferred stock provides additional equity needed to bolster the corporation's capital position.

By statute, Sallie Mae's voting common stock can only be owned by eligible financial and educational institutions and the majority of its directors are elected by those shareholders. Congress created Sallie Mae in a manner similar to several other corporations in that the constitutency, for whom the corporation was established, was expected to provide the underlying capital. Sallie Mae raised $24 million in the private equity markets in 1974. As of March 31, 1983, total shockholders' equity, including preferred stock and retained earnings, was approximately $360 million. Since January 1, 1981, the corporation's Board of Directors may also authorize the issuance of non-voting common stock to the general public.

The President of the United States appoints one-third of the 21-member Board of Directors and designates the Chairman from among the membership of the full Board. Sallie Mae's enabling legislative provides for the involvement in the corporation's financing activities by the Department of Education (only with regard to Sallie Mae's guaranteed debt financing) and the Department of Treasury. In addition, the Treasury Department is required by statute to provide the President of the United States and the Congress with a report on Sallie Mae's operations. Sallie Mae also is required to transmit to the President and Congress an annual report of its activities and operations.

In recognition of the Congressional intent that it exercise direction and control of the corporation, the Board of Sallie Mae has from its inception, provided an active stewardship over the corporation. This is in keeping with the determination of Congress to structure Sallie Mae along traditional corporation lines, with total responsibilities in the hands of a Board of Directors and a management teams.

Sallie Mae's enabling legislation requires the corporation to balance its public and private interests to assure the corporate financial and program objectives are in support of the GSLP. Sallie Mae, as a private for-profit corporation, is not expected to assume risks which would have a materially adverse effect on the corporation's ability to operate as a viable secondary market. Identifiable risks to the corporation come from regulations, operations, and financial and economic fluctuations. Sallie Mae also is a public purpose institution chartered by the government to support national goals in the area of student credit. As such, Sallie Mae is expected to play a leadership role, within the bounds of sound financial practice, in encouraging and supporting lenders in the continuation of GSLP lending activity and by setting standards which are widely acknowledged as supporting sound loan origination and administration.

An examination of Sallie Mae's program activities under its Loan Sale, Warehousing Advance and Commitment Programs reveals the extent of the corporation's support of the GSLP and the national objectives set forth by the Congress. Under its enabling legislation, Sallie Mae is authorized, pursuant to commitments or otherwise, to make advances on the security of, purchase or repurchase, service, sell or resell, offer participations or pooled interests, or otherwise deal in federally insured student loans or student loans that are insured by state or private guarantors participating in the GSLP. In 1981 Sallie Mae was authorized to provide similar secondary market services for non-insured student loans. The corporation is prohibited from dealing with institutions that discriminate on the basis of race, sex, color, creed, or national origin and from dealing with any commercial bank with deposit in excess of $75 million, which requires a customer relationship with the student or his or her family as a condition to receiving a student loan.

Under it Loan Sale Program, Sallie Mae offers to purchase loans made under the GSL and HEAL Programs. The Loan Sale Program provides funds to lenders and, because the corporation utilizes a network of third-party servicing agents, relieves those lenders of the administrative considerations relative to loan servicing. Through its Warehousing Advance Program, Sallie Mae provides liquidity to lenders against the collateral of their existing student loan portfolios of other U.S. government issued or guaranteed obligations. By statute, institutions with advances collateralized by insured student loans must either reinvest all advance proceeds into additional guaranteed student loans or maintain a specified student loan portfolio level throughout the term of the advance. Institutions offering other collateral must fully reinvest all advance proceeds. Sallie Mae also provides the assurance of future funds through the issuance of forward commitments. These commitments for both the Loan Sale and Warehousing Advance Programs, have enabled many state and private lenders to maintain lending arrangements through the assurance of continued student loan credit.

The provisions of the Education Amendments of 1980 and the Postsecondary Student Assistance Amendments of 1981 provide a major challenge to the corporation. In addition to broadening the corporation's flexibility in meeting liquidity needs as a secondary market, Sallie Mae was also authorized to be active in the student credit market on a limited, direct basis. Specific provisions authorize the corporation to consolidate and refinance student loans, lend funds directly to state agencies where there is a certified shortage of loan capital, to serve as a direct lender or guarantor in states where there is a severe student loan shortage, to provide secondary market support for non-insured student loans, to purchase and underwrite student loan revenue bonds, and to provide such additional services as determined by its Board of Directors to be supportive of the credit needs of students.

Since inception, Sallie Mae has made available over $9.2 billion of support to lenders under the GSLP through its Warehousing Advance, Loan Sale, and Commitment Programs. As of March 31, 1983, Sallie Mae's direct investment and commitments totalling $7.5 billion in the GSLP was equal to approximately 30 percent of all student loans outstanding.

In ten years of operation, Sallie Mae has worked with more than 1,600 lenders in 51 states and territories. These institutions include commercial banks, thrift institutions, credit unions, educational institutions, state agencies, and state secondary markets. Statewide direct loan and secondary market programs which have received assistance from Sallie Mae include Colorado, Florida, California, Michigan, Minnesota, South Carolina, Kentucky, Kansas, Virginia, Mississippi, Oklahoma, West Virginia, Iowa, Tennessee, Connecticut, Utah, Alaska, Wisconsin, and the District of Columbia.

Sallie Mae routinely does business with institutions of all types and sizes. These institutions include money center and regional banks as well as community oriented banks and thrift institutions and state agencies.

In terms of its business practices, Sallie Mae differentiates between high-risk lenders and high-risk student loans. Sallie Mae does not purchase loans unless they have been originated and maintained in compliance with appropriate statutory and regulatory requirements. However, the corporation does work with those institutions that are not in compliance to improve their understanding of these program requirements and generally has been able to complete transactions with the most of them. Sallie Mae believes that it has the responsibility to purchase portfolios of loans from lenders whose origination practices are satisfactory, even though some of these institutions may have shown relatively high incidences of default. As such, Sallie Mae's portfolio contains an above-average number of loans made by open-access lending institutions. Many institutions have indicated that they would not support the GSLP without Sallie Mae standing by as a secondary market outlet for the loans they originate.

Not all primary lenders are willing or need to utilize the secondary market. For many financial institutions the yields on these loans as well as other institutional factors encourage retention of student loans. However, knowledge of the existence of an accessible secondary market provides confidence to these lenders should they wish to utilize Sallie Mae.

Sallie Mae recognizes that as a secondary market, it has an important role in encouraging the primary market to lend to students in a nondiscriminatory and equitable manner. This understanding pervades Sallie Mae programs which reflect statutory requirements designed to encourage institutions to deal fairly with student borrowers. It is also reflected in the terms of the programs themselves, which attempt to balance the interests of lenders and the needs of Sallie Mae in a reasonable fashion. Sallie Mae also is deeply involved in assisting several states in their efforts to encourage student lending activities through the development of a direct lending capacity or in the establishment of effective state student loan guarantee programs. In addition, Sallie Mae actively promotes the use of its secondary market services to the financial community in the belief that the assurance of its support and participation will encourage the flow of private capital into the GSLP.

Sallie Mae is, under its Charter, a private corporation governed by a Board of Directors which is in part elected by shareholders and in part appointed by the President. Sallie Mae's primary public goal is to improve access to student loan credit for eligible students and their parents who wish to finance a postsecondary education through the Guaranteed Student Loan Program or the Health Education Assistance Loan Program. The corporation's position as a government-chartered enterprise implies a responsibility to encourage public interest objectives consistent with sound financial practices expected of a private business. The pursuit of these goals under its Charter is fully consistent with the intent of Congress and reflects a balanced approach on the part of Sallie Mae with regard to meeting its public and private goals in support of the GSLP.

Student Loan Marketing Association Balance Sheet, Mar. 31, 1983

	Millions
Assets:	
Student loans purchased, net	$3,434.8
Warehousing advances	2,956.7
Cash and short-term investments	791.8
Other investments	136.3
Other assets	204.2
Total assets	7,523.7
Liabilities and equity:	
Discount notes	91.8
Other short-term debts	383.5
Intermediate-term debt	1,450.0
Long-term debt	5,000.0
Securities sold—not yet purchased	136.6
Other liabilities	103.4
Total liabilities	7,165.3
Stockholders' equity	358.4
Total liabilities and equity	7,523.7
Commitments outstanding:	
Commitments to purchase	935.6

Lines of credit	207.4
Total commitments outstanding	1,143.0

PREPARED STATEMENT OF EDWARD A. MCCABE, CHAIRMAN OF THE BOARD, STUDENT LOAN MARKETING ASSOCIATION (SALLIE MAE)

Mr. Chairman, I am Edward A. McCabe, Chairman of the Board of Sallie Mae. With me today is the corporatation's President, Edward A. Fox.

If we may, Mr. Chairman, I would like to comment first— because my remarks are more general. Then Mr. Fox will add his more specific commentary on Sallie Mae's programs and operations—including a couple of matters that involve legislation.

Speaking for the Board of Directors, and for the fulltime management of Sallie Mae as well, I want you to know we appreciate this opportunity to meet with you. We want to do what we can to make these hearings useful to you and to the whole Congress. They are very helpful to us because they make us take still a nother look, in public, at how we're doing our job.

There are many facets to that job of ours, and they tend to become more numerous as time goes on. But the essential job you gave us, whatever, its facets, is to serve the needs of student credit. That is our central assignment. I believe we are handling it well, and I can asure you we are constantly trying to do it even better.

It's probably worth saying here that there is one thing we don't do and don t believes we should do. We do not involve ourselves in the process of making policy for federal or state help to students. That is the job of people like yourselves who are elected. We have plenty to do in the area of responsibility assigned to us. But, if every now and then our technical competence would appear useful to you as you assess the probable operating impact of a policy you are considering, we will be glad to respond to your call on that limited score.

You'll note I use the term "we," and the word is a good one to describe the way the Sallie Mae Board and Sallie Mae management work together. This is a 21-member Board and we're all outsiders; that is, no director is a Sallie Mae employee, and all of us have full-time occupations of our own. There aren't too many corporations where all Directors are outsiders, Mr. Chairman. So it's a tribute to the board and to the dedication of Mr. Fox and the whole management team that Board and management not only get along well, but also function well in the interest of Sallie Mae's mission—and of Sallie Mae's shareholders. Every Director devotes substantial time to Sallie Mae affairs. All serve on committees—Finance, Audit, Operations, and so on. The full Board meets every other month—the Executive Committee as need d in between. In all this, we work closely with management. It would be a rare week indeed where our President, Ed Fox, and I don't review several matters—personnel, programs, or plans—where the interplay of Board and management are required. Another example—we did some pretty innovative financing this past year. This involved the Board, working with management. But spot decisions need to be made in that type of activity, and the Board made the Finance Committee Chairman its clearance point for management on every major financing step we took. The Board sets policy for the corporation, but top management is involved in that process with us and sees to the execution of that policy. And here, Mr. Chairman, I want publicly to thank every Director for the energy, cooperation, and experience each provides us and for the special help all have given me. And in precisely the same vein I also want publicly to commend the excellent work of Ed Fox and the management team he has directed since we hired him as President just about ten years ago today. We've aged him a bit, but he's still pretty agile!

Mr. Chairman, this corporation has enjoyed enormous growth in its ten years of operations. For example, the Ware-housing Advance Program, by which money is loaned to lenders so they can make more student loans, had grown to $3.2 billion at the end of 1982. The Loan Sale Program, by which existing loans are purchased from lenders, had by the end of 1982 reached the same $3.2 billion level. And at the end of that first decade, Sallie Mae had business transactions with more than 1,700 lenders, nationwide. Along with its growth in assets—and we now have more than $8 billion in corporate assets—Sallie Mae has also grown in the complexity of its operations. We have instituted a wide range of programs to provide liquidity for lenders and to support the Guaranteed Student Loan Program.

The Community Lender Program, the Seller/Servicer Program, the Government Securities Advance Program, and the Loan Consolidation Program are a few examples. Aiso, and this is a very significant development, Sallie Mae over the past year has been raising all its operating funds in the public capital markets, thereby securing funds for its support of the Guaranteed Student Loan Program from private,

non-governmental sources. And, Mr. Chairman, it's gratifying to be able to report to you that our equity and debt offerings have been well received in the nation's financial marketplace. Earlier this year we sold $250 million of adjustable-rate, cumulative preferred stock, the first stock offering by the corporation since 1974. You will recall that the law specifies that our voting common stock can be held only by those postsecondary educational institutions or financial institutions that have qualified as lenders under the GSLP.

You should also know that our shareholders at this year's annual meeting approved an employee stock option plan that will utilize non-voting common stock. And as a current development, the Board last week directed that management, as part of its strategic planning, study and report to the Board [in July] on the capitalization of the corporation, including various alternatives to broaden Sallie Mae's shareholder base.

It is important that Sallie Mae as a shareholder-owned corporation show sufficient profits to be able to continue raising funds in the public capital markets. Profitability of the corporation must be viewed in those capital market terms, because without a strong balance sheet Sallie Mae could not raise the necessary capital, nearly $2 billion annually at this point, to provide the required support of student credit.

To do its assigned job, Sallie Mae must respond to the changing needs of the Guarantee Student Loan Program. To this end we are regularly examining a range of programs to suit the varying needs of different lenders, and to respond quickly to changes in the basic loan program. I mentioned earlier that we have taken a number of innovative financing steps, and we have tried to keep your subcommittee apprised of those steps—because we want you to know what we are doing, and why. For example, we recently reviewed with you and with other appropriate governmental groups our interest in acquiring a financial institution subsidiary. We would take this step, not because we are interested in going into the banking or S&L business, but because this type of subsidiary seems to us the most practical and effective way to support the growing volume of student credit represented by student loan revenue bonds.

As I said earlier, there are significant things we do, like those I've cited, and we want you to know about them. We won't burden you with every detail, but I promise you we'll continue to visit with you about the more important steps, the sizable steps, and some of the just plain interesting steps we take—even though they very likely won't require any legislative action. To repeat, we want you to know what we are doing—and why.

Now and then—and we have a couple Mr. Fox will discuss today—there will be an item or two where we believe legislation is called for so we can do our job better.

Finally, Mr. Chairman, let me say for Sallie Mae that as we continue our support of student credit, we applaud the fact that other entities are moving into this field too. The market place is out there for all, and we seek no monopoly. I want to emphasize that, Mr. Chairman. We ask no monopoly. We expect to thrive with competition. We think we can do this job in a more efficient and more cost-effective way than anyone else. So I'll put everyone on notice that we're going to continue trying to do just that.

Thank you for the time, Mr. Chairman, and thanks, too, for your committee's interest in the work we do. After Mr. Fox's remarks we will try to answer any questions you have.

STATEMENT OF EDWARD FOX, PRESIDENT OF SLMA (SALLIE MAE), ACCOMPANIED BY EDWARD McCABE, CHAIRMAN OF THE BOARD OF DIRECTORS FOR SLMA (SALLIE MAE)

Mr. McCABE. If we may, I would like to comment first because my remarks are more general. Then, if it's all right with your scheduling, Mr. Fox would add his more specific commentary.

Mr. SIMON. Fine. I might add for you as for the other witnesses, we will enter all statements in the record so if you wish to just summarize, informally that's perfectly proper.

Mr. McCABE. Well, I would prefer to do that, Mr. Chairman.

Mr. SIMON. OK.

Mr. McCABE. I am Edward A. McCabe. I am an attorney in Washington, with the firm of Hammill, Hart, McCabe & Saunders

and, as the Chairman mentioned, I do serve as the chairman of the board of directors of Sallie Mae.

I might say as an aside, Mr. Chairman, on a personal note, I am always particularly pleased, Mr. Chairman, to be back at this committee. In an earlier life, when you gentlemen were not yet full involved in public affairs, I had the privilege of serving as general counsel for this committee and so anytime I hear of anything coming out of or have the opportunity to be with the Committee on Education and Labor, I am delighted and it's kind of a personal coming home.

Mr. SIMON. We're doubly pleased to have you here, Mr. McCabe.

Mr. MCCABE. I might say the only member of the committee who is still in active service here, who was here when I was counsel is the Chairman, Mr. Perkins. He is a friend of longstanding and I am delighted to be with all of you.

Let me say, Mr. Chairman, and I will have to ad lib as I go along here along with the prepared statement, that speaking for the board of directors as well as for the full-time management of Sallie Mae, I want to emphasize how pleased we are to have the chance to come here and meet with you because we want to do all we can to make these hearings as useful to you and to the whole Congress as possible. They certainly are helpful to us because they give us still another chance to review and to do it in public—how we are doing and what we are doing.

We are doing a number of things. The facets of our job become more numerous as time goes on, but the central assignment you gave us is to serve the needs of student credit. That's our job and I believe we are handling it well and I want to assure you that we are constantly trying to do it even better.

It is probably worth saying that there is one thing that we don't do and don't believe that we ought to do. We don't involve ourselves in the process of making policy for Federal- or State-helped students. We view that to be the job of people like yourselves who are elected. We have plenty to do in the area that is assigned to us. But every now and then, it does happen, our technical competence might appear useful to you as you assess the probable operating result of some policy you are considering, if that is the case, we will be very glad to respond to your call on that limited kind of score. But we don't want to involve ourselves in the policymaking of education aid as such. That is not our role.

I do use the term "we" in describing the way the Sallie Mae Board and the Sallie Mae management work together and I think it is a very apt term. This, as you may recall, is a 21-member board of directors and we are all outsiders. That is, no director is a Sallie Mae employee. All of us have full-time occupations of our own.

There aren't too many corporations where all directors are outsiders, Mr. Chairman, and I view it as a tribute to the board and to the dedication of Ed Fox and his management team that this board and management not only get along well, but also function well in the interest of Sallie Mae's mission and of Sallie Mae's shareholders.

Every director devotes substantial time to Sallie Mae affairs. Each serves on committees—finance, audit, operations, and so on. The full board meets every other month. The executive committee

meets as needed in between. In all this we work closely with management. It's a rare week, indeed where our president, Ed Fox, and I don't review several matters—personnel, programs, or plans—where the interplay of board and management are required.

I might give you a specific example of this coordination and working together. We did some pretty innovative financing over this past year. This involved the board working with managment. But spot decisions need to be made and they need to be made quickly in that type of activity. The board made the chairman of the finance committee its clearance point for management on every major financing step we took.

The board is involved, sets policy for the corporation and top management is involved in that process with us and sees to the execution of the policy. Right here Mr. Chairman, I would like publicly to thank every director for the energy and cooperation and experience each provides and for the special help they all have given me. In the same vein, I want publicly to commend the excellent work of Ed Fox and the management team he has directed since we hired him as president just about 10 years ago today. I guess we have aged him a bit, but he is still pretty agile and gets the job done.

We have heard, Mr. Chairman Mr. Cavanaugh's comments of some of the growth of Sallie Mae over the past 10 years. Its assets at the end of that decade have grown to about $8 billion. We have necessarily grown in the complexity of operations at the same time. We have instituted a pretty wide range of programs, all designed to provide liquidity for lenders and to support the underlying guaranteed student loan program.

In addition to these specific programs, and I want to underscore again a point made in Mr. Cavanaugh's testimony because I think it is a very significant development—Sallie Mae, over the past year, almost year and a half, has been raising all of its operating funds in the public capital market, thereby securing funds for support of the guaranteed student loan program from private nongovernmental sources.

It's gratifying, Mr. Chairman, to be able to report to you and your colleagues that our equity and debt offerings have been well-received in the Nation's financial marketplace. Earlier this year, we sold $250 million of adjustable rate, cumulative preferred stock. That was the first stock offering on a corporation since 1974.

You will recall that the law specifies that our voting common stock can be held by those financial institutions or postsecondary educational institutions that are qualified as lenders under the guaranteed student loan program.

You should also know that our shareholders at this year's annual meeting approved an employee stock option plan that will utilize nonvoting common stock. There is also a current development. The board last week directed that management, as part of its strategic planning, study and report to the board in July on the capitalization of the corporation, including various alternatives to broaden Sallie Mae's shareholder base. It is important that Sallie Mae, as a shareholder-owned corporation, show sufficient profits to be able to continue raising funds in the public capital market.

Profitability of the corporation must be viewed in those capital market terms, because without a strong balance sheet, Sallie Mae couldn't raise the necessary capital—that's nearly $2 billion annually at this point—to provide the required support of student credits.

To do its assigned job, Sallie Mae must respond to changing needs in the guaranteed student loan program. To this end we are regularly examining a range of programs to suit the varying needs of student lenders and to respond quickly to changes in the basic programs. I mentioned earlier that we have taken a number of innovative financing steps and we have tried to keep your subcommittee apprised of those steps because we want you to know what we are doing and why.

For example, we recently reviewed with you and with other appropriate governmental groups our interest in acquiring a financial institution subsidiary. We would take this step, if we do, not because we are interested in going into the banking business or into the S&L business, but because this type of subsidiary seems to us the most practical and effective way to support the growing volume of student credits that is represented by student loan revenue bonds.

As I said, there are significant things we do, like those I have cited and we want you to know about them. We won't burden you with every detail, but I promise you we will continue to visit with you about the more important steps, the sizable steps, and some of the just plain interesting steps that we take, even though, very likely, these won't require any legislative action.

We want you to know what we are doing and why we are doing it. Now and then—and we will have a couple—Mr. Fox will discuss today—there will be an item or two where we think legislation would help us do our job better.

Finally, Mr. Chairman, let me say for Sallie Mae, that as we continue our support of student credit, we applaud the fact that others are moving into this field. The marketplace is out there for all of us and we seek no monopoly. I want to emphasize that, Mr. Chairman, and we ask no monopoly. We expect to thrive with competition. We think we can do this job in a more efficient and a more cost effective way than anyone else.

I will just put everyone on notice that we are going to continue trying to do just that.

Thanks for your time, Mr. Chairman and thanks, too, for the interest your committee has. After Mr. Fox's remarks we will try to answer any questions you have.

Mr. SIMON. Thank you very much.

Mr. Fox.

Mr. Fox. Thank you, Mr. Chairman. I will just try to highlight a couple of points quickly and then get to certain legislative matters and then get to the questions.

Very quickly, in 10 years of operation we have provided more than $9.2 billion of support under the GSLP. Today our $6.5 billion of loans outstanding, plus our commitments, are equal to approximately 30 percent of all insured student loans outstanding. We work with 1,700 lenders in 51 States and we have provided financing statewide in 18 State programs and to the District of Columbia.

You have heard that we raised $2 billion in 1982. You also understand that that's with higher cost than we would have done through the FFB, and I think it's important to note that we were able to raise this money even at higher costs without raising our prices to our customers. In fact, during the past 1½ years we have actually lowered the cost of doing business with Sallie Mae to many customers as we pass through the benefit of operating efficiencies.

We talked about our $250 million preferred stock issue. It is worth reiterating that the success of this offering was largely the result of the very strong balance sheet and the long-time earnings record of the corporation. Referring a moment to our profits in 1982, our total profit was $69 million. Of that amount, $31 million was provided to pay the related Federal income tax liability, $2 million was paid to stockholders in the form of dividends, and $36 million was added to the retained earnings account of the corporation, and was available for reinvestment of student loan assets.

We earned 62 cents on each $100 of invested funds in 1982 and I am pleased to report that this was significantly improved over the 45 cents that we earned in 1980 and 1981 and reverses an earnings downtrend of prior years.

We talk at length about specialized products in our submitted testimony and just very quickly that we have a special program for member institutions of the United Negro College Fund and we have a special program for health professional institutions under the health education assisted loan program and we have put in place over the last 2 years a community lender program recognizing the needs of smaller institutions.

It is important to note that we are not a retail lender. Our programs are designed to meet the growing needs of a variety of very differing financial, educational and State institutions. I am pleased that in support of State primary and secondary markets, we have redesigned; simplified and lowered the cost of our existing products that we have offered to the State agencies and the State secondary markets. In addition, we will be offering new products designed to meet the needs of these State agencies that will result in lower bond prices and, hopefully, lower fees paid by those institutions.

Speaking specifically about some legislative needs, we are appreciative of the support of the Congress in providing a technical amendment to an enabling statute which provided that "the priority established in favor of the United States by section 3466 of the revised statute shall not establish a priority over the indebtedness of the Association issued or incurred on or before September 30, 1984." This issue has created a temporary waiver as it is limited to debt issued or incurred prior to September 30, 1984.

If this limitation is not removed before that date, Sallie Mae will find itself unable to finance its activities to fund outstanding commitments to fulfill its congressional mandate. We would hope that, at the first opportunity, that that would be extended.

Additionally, we would point out that our full faith and credit guarantee also expires on October 1 and that if the Federal priority is not extended we would not be able to continue in operation. In dealing with the public credit markets, we cannot afford to erode the confidence which has been built over the past 2 years. We are

particularly appreciative of the kind comments that the Fiscal Assistant Secretary of the Treasury who was here just a few moments before.

To risk even a hiatus in funding activity in 1984 is to create potential dire consequences for the future existence of this corporation. We ask you to give serious consideration to extending the Federal priority amendment at the earliest opportunity.

As indicated earlier, the 1980 amendments clarify Sallie Mae's ability to lend directly to States. The Department of Education has reviewed the statute and has concluded that States borrowing from Sallie Mae on a direct basis would qualify for only a half special interest allowance.

Many States have approached Sallie Mae during the last few years during difficult times in the student loan revenue bond markets seeking financing from Sallie Mae. The interpretation given to our authority by the Department has prevented us from providing this assistance. Resolution of this issue is of critical necessity for giving alternative sources of financing to the State lending agencies.

Using data from the Congressional Budget Office, the Joint Committee on Taxation and from the Department of Education, we have estimated that the use of a loans-to-States program would actually save the Federal Government money in the operation of the GSLP compared to alternative forms of financing. It is our understanding that the Department of Education is supporting a technical amendment to the statute which would allow the States to receive a full special allowance on loans made from funds advanced to us as long as the income of such advances were taxable. We are gratified for that support.

Mr. Chairman, I testified before this subcommittee in February on the operational problems associated with the new student loan disclosure provisions enacted in the Financial Assistance Technical Amendments of 1982. I sincerely appreciate your efforts to help resolve this difficult issue. It is interesting that implementing these provisions could cost Sallie Mae alone several million dollars for little benefit to students.

We look forward to working with the subcommittee in working out appropriate solutions to the current problem. We wish to emphasize that we believe that useful and complete loan information can and should be disclosed to borrowers in a way that is readily comprehensible to them, that such disclosures can be made both at the time of the origination of the loan at the time of loan repayment, in a manner that can be accommodated by the automated systems currently used in the GSL program.

We recently notified this subcommittee and the Senate subcommittee that the Sallie Mae Board of Directors voted to authorize corporate management to pursue an acquisition of a finance subsidiary.

The subsidiary financial institution would, of course, remain subject to the same statutory limitations placed on the parent corporations by Congress in section 439 of the Higher Education Act.

Sallie Mae's acquisition of a financial institution will expand our capacity to serve our customers and our social purpose. By utilizing the resources of an existing financial institution, we will build a

better base for delivering our products and service. We are discussing this acquisition with our staff and will continue to do so.

Finally, I will be testifying before this subcommittee on June 8 and at that time will provide far greater detail on the Sallie Mae options programs and our concerns.

However, I would like to make two points. First, loan consolidation and the process and procedures by which a consolidated loan is created is extremely complex.

Servicing of graduated repayment loans is also extremely complex. I cannot emphasize too strongly that the structure of any loan consolidation program is critical. The simple fact of consolidating a student's indebtedness is inherently so complex that the structure of the program should not add to the problems.

We look forward to working with this committee and we look forward to continuing to offer the options program.

Second, Mr. Chairman, as a businessman, I cannot endorse the concept of a monopoly. Your subcommittee has the difficult responsibility of determining the policy implications of program costs to the Federal Government. That is your concern.

Sallie Mae would like to continue to offer options. We, however, leave to your judgment and that of the subcommittee, what other consolidation programs should be available and the costs of the Federal Government associated with those additions.

However, Sallie Mae will neither request nor do we require a monopoly in the options program. That summarizes the testimony that we have prepared for you in greater detail and certainly Mr. McCabe and myself would be pleased to answer any questions which you might have.

Mr. SIMON. Thank you very much.

First, a very general question. If you were to draft the statute that we are going to have to be coming up with very shortly, what would you include in it?

Mr. FOX. The first thing I would ask for, Mr. Chairman, would be an extension of our Federal priority for removal of the limitations on our Federal priority issue. This is certainly of the greatest importance to the corporation.

Second, the loans to States programs, which we have discussed and which was granted to the corporation in 1980, should be technically clarified so that those states, who from time to time could use such a program, would have available to them alternative sources of financing. It is, I think, folly to build programs around a single source of financing. We should leave to those who are required to finance this program the greatest number of alternatives or options to them so they can assure continuity in the financing of their programs.

Third, we would ask you to extend the options program. We feel it is a fine program, it is serving its mission. There are a limited number of people out there who require it and those people should have the opportunity to extend through graduated repayment the payment terms of their indebtedness to assure that they can pay back in a timely basis without going into default.

There may be a technical amendment or two relative to the options program, but, essentially, those are the major items affecting us.

In addition, we think that it is very important that disclosure be clarified. It is essential that we get it to a position where all institutions can disclose on a common basis using existing systems in such a way that students are appropriately apprised of their responsibilities, but the operational aspects of disclosure are considered in your legislation.

Mr. SIMON. So that I understand precisely what the problem is and where we are going, I would like to ask why you got involved in the State programs.

Mr. FOX. State agencies have had a broadened role during the last 5 or 6 years in the management of the guaranteed student loan program. During this period, they have become not only guarantors, but many have become originators of student loans in areas where there is insufficient capital. They provide secondary markets sometimes in competition, sometimes in addition to the services that we offer. They have become servicers in many areas. They provide a broad variety of responsible services to their constituencies on a State-by-State basis. The trend of legislation has been to go in that direction in the last 5 or 6 years.

We, as the national secondary and provider of capital, support them just as we provide support for lending institutions and for education institutions. We provide commitments which are permitted under our statute which commitments give them the comfort of extending credit or providing service knowing that we will be behind them and can undertake to buy their loans at some time in the future, to provide credit to them, and to provide servicing to them.

In this variety of ways, we serve them just the same way in which we serve the banking institutions. We are able to assure them in the variety of ways a continuity of money so that they can continue to support this program.

One of the real problems that we have with the cyclicality of the availability of credit in the banking system. Whenever we have a credit crunch, it is the consumer who loses out first and it is the student consumer who loses out among consumers because this is a low-yielding program and a difficult one to administer and when credit is being rationed it is frequently the student who loses first.

That is one of the reasons why we exist and to the extent that we can provide assurances to those who extend credit to the students, that we will be there when their sources of funds dry up or are no longer available, we are doing our job for those constituencies and to the broadest extent that we can offer the widest range of programs to them, we give them opportunities at their choice to serve the students in the best ways possible.

Mr. SIMON. But you get involved there if their State does not issue bonds or they can't borrow from local banks? I am a little fuzzy still on why you get involved with, say, the State of Illinois or——

Mr. FOX. Well, the State of Illinois runs a number of programs. Because it is a unit banking State, they have a number of institutions, many of which are very small, and those 4,000 institutions that are eligible to originate student loans in the State are looking for some assurance that if they extend credit in support of the programs, their will be somebody there to buy those loans, if it's neces-

sary, that if they need capital to lend out, they can borrow from us, that if they can get a commitment from us that we will be willing to do those things at some point in the future, they have the assurance that as they support the program, there is somebody behind them who will stand up for them and let them get their money back so they continue in the programs.

States operate frequently with no less a necessity for a take-out, whether that take-out or credit comes from the banking system, comes from Sallie Mae, comes from insurance or whatever, the fact that they have these opportunities to be provided with ancillary credit, ancillary support, strengthens those institutions and gives them the opportunity to be more imaginative, more constructive in their own jurisdiction, to provide more credit, with the assurance that there is somebody behind them.

With somebody like Sallie Mae who has done nearly $10 billion worth of business in the student loan program, and is willing to stand up and, indeed, is willing now to even improve its programs to the States, I think that the fact that we are there will enhance their willingness to provide credit, for example, in Illinois.

Mr. SIMON. Then one final question.

You touch in your formal statement on a problem that I have run into recently several times. "We would suggest that during the reauthorization process, this committee seriously examine the small loan problem."

Mr. Fox. Yes, sir.

Mr. SIMON. This is a problem particularly from you and me generalizing on the basis of isolated incidents. But someone signs up for $500 to take a course at a trade school. Trade schools traditionally serve minority and lower income people more than others. Probably, so that student who wants $500 is not from a family that is going to be a particularly attractive loan possibility to the local bank.

But that $500 situation falls through the cracks right now and I assume this is what you are referring to here.

Do you have any specific suggestions as to how we meet that problem?

Mr. Fox. Well, let me say at the outset that when Sallie Mae does business with institutions we never look through the portfolio to see what institutions people are attending. We don't limit the loan sizes that we will buy. We are looking at the average indebtedness of the portfolio because that is the characteristic that is more important to us. But we have never ever limited the loans that we will buy by any mandated dollar limitation.

The real problem here——

Mr. SIMON. If I may just interrupt. When you say you look at the average indebtedness, if that average indebtedness level gets too low, do you get involved?

Mr. Fox. Yes; we will. If it gets too low, we will not buy those loans at a par price, which is an inhibitant to be sure, but we have never ever told any institutions that we will not buy low balance loans nor that we will not buy a portfolio of loans that qualifies as an insured portfolio.

About 25 percent of the loans that we buy actually have totally borrowing indebtedness of below $2,500 so most institutions with

whom we deal—in fact, I would say 95 or more percent—are able to show us portfolios which are made up of small loans and intermediate-sized loans and large ones, which, in the average, meet our parameters for acquisition at a par 100 cents on the dollar price. And when we actually go back to the computer, we find that about 25 percent of our loans which you would characterize as small—the person who borrows for 1 year—this is not just a trade school problem, as a matter of fact, it is not even a student loan program—we find that community colleges are in this same category.

If you extend credit only once because the student is going to a short-term program or is going to a low-cost program. you create the small loan.

This is a nationwide banking problem. Banks today are passing along costs associated with banking and products more than they have ever done before. On the liability side, they are paying much more for deposits and many, many banks are establishing minimum loan sizes for all of their consumer lending—$1,500, $2,500, and even, in some cases, over $3,000.

So we can't just deal with the student loan in a vacuum and say that there are some arbitrary standards here. It is the entire banking industry looking at the costs associated with the originating and delivering of a loan and saying to the person that has to pay for it, "That loan has to carry itself."

We started looking at a variety of ways in which we might be able to deal with this thing. Quite frankly the costs associated with a loan are pretty much constant whether it's a very small loan or a very large one. It's very difficult to conceptualize how we can come up with something inceptionally that can meet that problem.

I know that there are some commission reports coming out from the National Student Commission on Education. We know that there are some talk about forming some committees to discuss this thing in the near term, different ways in which you can look at it.

We are thinking that the possibility exists that a little piece of plastic, like a debit card or something, like when you borrow money on your overdraft privilege in your bank and there might be something that we might be able to work out through a financial acquisition of an institution if we were to own a banking institution.

But these are conjectural. We are dealing with a changing financial environment where the whole delivery mechanism in the financial services is changing.

I think there is a solution. It can't be cheap. I am not sure who is going to bear the costs for it, but we are willing to sit and talk with people to try and find a solution for this thing. But I can assure you that our corporation provides no inhibitants or artificial limits nor do we specifically exclude paper of that size in our purchases.

Mr. SIMON. I might just add that sometime this fall I hope to get together with the subcommittee members and the staff to discuss where we are going to go on reauthorization of the Higher Education Act, and any ideas you might have prior to that time, I would welcome.

Let me just add a word of commendation. You are not only handling things well from what I sense, but you are using some imagi-

nation and creativity—the United Negro College Fund, the consortium you testify about—we appreciate that.

Mr. Fox. Thank you very much.

Mr. SIMON. Mr. Erlenborn.

Mr. ERLENBORN. Thank you, Mr. Chairman. I thank you particularly since I am not officially a member of your subcommittee.

Mr. SIMON. Well, you so outrank all the rest of us in terms of seniority and age—[laughter]—that I thought we should defer to you.

Mr. ERLENBORN. I just may take that thanks back.

Let me first of all apologize to Ed Fox and Ed McCabe for being late. I had intended being here to hear all of your testimony, but I had some dental work scheduled this morning. In fact, I feel like I must look like I have Bells Palsy because it's still frozen over here.

Let me ask one question. The chairman, just a moment ago, said that the subcommittee would be getting together to discuss the extension or reauthorization of the higher education Act.

Do you feel that the problems of Sallie Mae that you have discussed here this morning that need some legislative attention can wait until the higer education is extended or do you feel that separate legislation might be desirable?

Mr. Fox. Mr. Erlenborn, the major problem we have is with a program which has a sunset provision on July 31 of this year. It is a program that I think has proven both necessary and attractive to a small group of students who require loan consolidation and extension of their indebtedness.

We also have a September 1984 date at which time our Federal priority issue must be addressed. There are certain technical amendments that we think are essential and I would strongly urge that this committee and the full Congress deal with these issues as soon as possible rather than wait for reauthorization. We have only about 60 days before one of our programs expires. Actually, at this point in time, we are going to have to start no longer accepting applications with the assurance that we can provide accommodation in that options program because of the very complex 60 to 90 day lead time to close. So we strongly urge that whatever legislative initiatives could be undertaken be accomplished by July 31 of this year, if possible.

Mr. SIMON. If my colleague would yield.

Mr. ERLENBORN. Yes.

Mr. SIMON. Clearly we have to act as quickly as possible and we will make every effort to do so.

Mr. ERLENBORN. Thank you, Mr. Chairman. I have no further questions. I just want to compliment both of you on what you have done with, what I consider to be "my baby," Sallie Mae. She has grown up quite well.

Mr. Fox. Thank you.

Mr. SIMON. Mr. Kogovsek?

Mr. KOGOVSEK. I have no questions.

Mr. SIMON. Mr. Coleman?

Mr. COLEMAN. I was wondering about your taking a savings and loan bank into the fold and what you anticipate utilizing those services for. How will it improve your services? How can we get a home mortgage from you or something like that? [Laughter.]

Mr. Fox. Would you like to go first, Ed?

I guess we both have addressed that issue Congressman and maybe the key point is that, if we do this, if we get a financial institution as a subsidiary; the only reason that we would do it is to improve our capacity to serve the needs of student credit. We are not interested in going into the banking business as such or the S&L business as such, but student loan revenue bonds reflect a very large chunk of today's student credit market and this is a way we see to service that need and that's our purpose!

Mr. COLEMAN. Will there be any competitive advantages that you might have over a privately held S&L?

Mr. MCCABE. I don't think so. The missions of S&L's have changed since the Garn-St Germain legislation in the fall of last year, so that we could actually run this as a student credit institution rather than as a mortgage institution and be well within the charter responsibilities of a savings and loan institution.

In our letter to you, we said that we have a specific laundry list of things that we are permitted to do under statute, that we would do more through the acquisition of a savings institution or other financial intermediary than those responsibilities already given to us in our role as a secondary market and supporter of postsecondary education.

Mr. COLEMAN. Well, let me ask you a question. Is that because you think you have that authority or you would just as soon not take on extra services?

Mr. Fox. We certainly don't have the responsibility to become a mortgage institution and would not even choose to do so. There is the possibility that at some point in time in the future, we may be required under our franchise to provide uninsured student loans to those who have been disinfranchised from the guaranteed student loan program. As you have put in needs analysis and the like, an authority you gave us a couple of years ago to provide an uninsured program for those people, might best be served through a loan program managed through a banking institution.

But outside of that authority and the revenue bond authority Ed McCabe just discussed that you gave us, and granted, that there are billions of dollars of revenue bonds being sold each year. Our participation in this market can only have a beneficial impact on the costs to the issuers by our participation.

We think that we can use this institution with a modest deposit base to support higher education and protect education in ways that we have been franchised to do it.

We already have a couple of retail banking programs. For example, in the health area we offer loans as a lender of last resort to students going to the various health profession institutions around the country providing lender of last resort service. We make about a quarter to a third of those loans in the country right now. It's a modest program, but we actually pay a good deal for a banking institution to do a lot of the work. If we could do it within the institution, we could deliver that program more expeditiously and less expensively and provide more service.

The program that we are talking about here, the options program, we actually have to go through the banking system for certain aspects of that to pay off loans and the like. We could do that

through a banking system. We could set up a servicing capacity because savings institutions have traditionally been in the servicing business.

The revenue bonding we talked about before.

I think you would find that in a period of about 3 to 5 years the institution would look exactly like Sallie Mae looks now except that the delivery mechanisms and one or two of the products, like the revenue bonds, would be slightly different. But those are products that you have already authorized us to deal with and where we find that we have difficulties through existing tax law or structure in delivering, we certainly would have an ongoing discussion of everything we would do in that institution with the members. You have oversight over us and you would continue to have oversight over our activities and we would be discussing anything having to do with this institution with you before we would do it, as we have done in the past.

Mr. COLEMAN. Have you made any noninsured loans?

Mr. FOX. No, at this point in time, we have provided a small line of credit to a consortium of schools through a bank here in the District for a total of $3 million, which we have discussed in our testimony. That line has induced the bank to make loans available to parents of students going to the nine consortium schools here in the District of Columbia.

That program is starting this summer. It is a pilot authorized by our board and we are curious to see how that resolves itself. Other programs around the country have been created through revenue bonds or through other sources to provide accommodations to those upper-middle-income families who are sending their kids to higher cost institutions.

We are also negotiating with one or two other institutions for very small pilots, but there is nothing in place and we would be very surprised if in the near future, any significant sums would be expended by Sallie Mae.

Mr. COLEMAN. Thank you, Mr. Fox.

Mr. SIMON. Mr. Ackerman?

Mr. ACKERMAN. Would you have any interest in opening things such as branches on different campuses on a selective basis?

Mr. FOX. I don't really see any point for us to be doing that. Our mission is to serve the banking industry and to serve the education industry. To the extent that there might be a campus in the very immediate area in which our institution might be located, it might be appropriate to do so. But we are not looking to be a full-service banking institution. We are looking really to unbundle banking services and we would not wish to compete with the banking system or to compete with the originators in that community unnecessarily.

Mr. ACKERMAN. Thank you, Mr. Fox.

Mr. SIMON. Mr. Gunderson?

Mr. GUNDERSON. No questions, Mr. Chairman.

Mr. SIMON. We thank you both very, very much for your testimony and you will be hearing from us shortly.

Our final witness is no stranger to this room, Bill Clohan.

Oh, I guess Bill is not the final witness. We have a panel later on. I'm sorry. I am looking at the first sheet here.

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Not the final witness of our hearing this morning is Bill Clohan, general counsel for the Association of Independent Colleges and Schools, and, of course, no stranger here in our midst.

STATEMENT OF WILLIAM CLOHAN, JR., GENERAL COUNSEL, ASSOCIATION OF INDEPENDENT COLLEGES AND SCHOOLS

Mr. CLOHAN. Thank you, Mr. Chairman. It is a pleasure always to come back to former stomping grounds and to meet with you on an important subject like Sallie Mae. I represent the Association of Independent Colleges and Schools, which is an association of approximately 570 colleges and schools throughout the country enrolling over 450,000 students.

I would like to say before beginning that my colleague David Shefrin was unable, unexpectedly, to be here this morning. He passes his greetings to you. He spoke with you at the United Jewish Appeals the other day on Sunday and he really apologizes for not being here. His school if you ever get a chance to go to the Hartford, Conn. area or New York City area, is really on the cutting edge of computer technology in training students how to deal with computers.

The Student Loan Marketing Association, very much like the guaranteed student loan program, has matured during the past several years. Both have expanded tremendously. Ed Fox has given you some of the details on their growth and assets, earnings, dividends, and so forth. I have to compliment them on doing an excellent job in carrying out the mandates of the original authorization and also the 1980 reauthorization authorities.

They serve a very difficult role. On the one hand, they are a quasi-governmental private corporation who has corporate responsibilities to its shareholders and, on the other hand, have a public purpose or a public responsibility to insure, to the extent that they can in providing liquidity, GSL access to students attending all institutions.

There have been many critics of Sallie Mae over the years. It's my belief that most of the criticism comes from a misunderstanding or lack of knowledge about their operation. I have to admit that it is a rather complex operation and, perhaps represents the complexities of the entire guaranteed student loan program.

Any time you have a program that deals with third party nongovernmental agencies where the process works only when there are proper incentives in that system, there is much potential for a falling down of the system if those incentives don't work.

There are many different actors in the process—lenders, secondary markets, State agencies, students, and so forth and, as we will see later, bond issuers, and so forth.

During the past few years the Congress has given new authorities to the Student Loan Marketing Association. It's my intent this morning to get into them—the bankruptcy priority, the consolidation authority, the purchase of an S&L, the question of whether they are subject to State taxation or whether their purchasing loans from State agencies would allow the States to receive the full special allowance; lender of last resort, where some States are skeptical of what Sallie Mae intends by that—I will not get into.

I would like to concentrate on the one subject that really impacts the schools that the Association of Independent Colleges and Schools and it is also my feeling, although I don't represent them, that the community colleges are adversely affected, as Ed Fox pointed out.

I would like to say at the beginning that it is not the policy of Sallie Mae, per se, which adversely affects low or short-term borrowers or short-term course borrowers, low loan-size borrowers. It's perhaps the Federal policy. Mr. Fox noted that the problem is not only indigenous to the guaranteed student loan program, it's true in all consumer banking activities. The costs of making a small loan, of administering that loan and of collecting on that loan is approximately the same, no matter what the loan principal. Because of that, there is a built-in disincentive for lenders to make small loans, and frankly, in terms of Sallie Mae and other secondary markets, there is a disincentive to purpose those loans, once the loans have been made.

I think that Congress—I encourage Congress to deal with the issue of trying to turn the incentive in such a way that it is equally advantageous for a lender and a secondary market purchaser to both make and respectively purchase the small loan.

Mr. Fox noted that the community colleges were affected by the small loan problem. I really appreciate him identifying that problem and also I will gladly take up the encouragement to meet with him and other participants in the program to try and work out a solution that maybe we can present to you.

The community colleges of this country and the proprietary institutions of the country do represent a much greater proportion of low-income students and minority, and by that fact, if there is a disincentive to make loans to these types of students, I think it does not carry out the primary purposes—or one of the purposes of the guaranteed student loan program.

I refer to the testimony of the Comptroller of the Department of Education. It was presented before the National Commission on Student Financial Assistance in January. I would like to read just briefly some of his remarks. This is on page 4 of my testimony.

> Lenders and secondary markets alike recognize that small loans cost just as much as large ones to service and the result is that certain categories of students, primarily vocational and college freshmen, are beginning to experience difficulties in obtaining loans until they complete their first year of school.

He goes on to say that:

> Traditionally, students attending vocational schools come from lower income families and need financial assistance to go to school. As most vocational programs are of one or two years in duration these students will not have sufficient average indebtedness to make lenders or secondary markets servicing costs economically viable.

If I were a banker and had three students come into my bank and I had $5,000 in loan capital that I could use to make student loans to them, and two of them wanted a loan for $2,500 each and the other student happened to be a graduate student going to Northwestern or Southern Illinois University and I realized that the return for the one single loan to me—or the benefit that I would receive from the Federal Government and the student will be the same for both loans, but my costs of making and servicing

the two loans individually to make the $5,000 would be much greater, I would probably, based on pure economics, make the loan to the single graduate student.

That's the dilemma that I think Congress needs to deal with.

I only lay out generally possible solutions. The key is to establish additional incentives for loans made to students attending short-term courses or those that only want to borrow less than $2,500.

One possibility would be to increase the special allowance, disproportionately to the size of the loan principal. By that I mean, if a student only wants to take out a $1,500 loan or only is required to or only allowed to because of the remaining need test that was imposed by Congress several years ago, then the banker would be paid an additional special allowance for making that particular loan, and wouldn't have a disincentive to make that loan.

Another way to deal with it is to have the Government pay an origination fee to the lender, which would be larger for small loans at the time of origination. A third possibility would be, make a supplemental payment to any secondary market, such as Sallie Mae at the time they purchase the portfolio. I agree, as Mr. Fox related that they do not look at each loan in a portfolio that they are considering for purchase. The problem occurs in those isolated banks throughout the country who may be only providing student loans to community colleges or vocational schools or in States such as Arizona, where we had a problem in 1979, where the tuition costs are very low. Both the State universities—and there are very few private institutions in Arizona—and the proprietary institutions have low tuition costs. Therefore, the average loan indebtedness is low. There are no high tuition schools to which a lender can make loans to those students to raise the average indebtedness in that portfolio.

Therefore, their only alternative is to decide not to make student loans, because liquidity is the grease that makes the system run.

Sallie Mae provides that liquidity by purchasing the loans primarily as they go into repayment. If that liquidity is not there, the lenders are probably not going to make the loans in the first place because they have other places they can use their loan capital, other types of consumer lending.

One thing that I would encourage—this is not in my written testimony—in reviewing the annual report of Sallie Mae for 1982, I was struck by the fact in looking at the Board of Directors, there is, to my knowledge, at least I couldn't tell it by looking at the names and who they represent, no representation from proprietary institutions and, I believe, no representations from community colleges, per se, even though Bill Arseno (phonetic) represents the State Department of Education in Louisiana.

Four of the representatives either currently or in the recent past have been associated with independent institutions, traditionally elite institutions. I know many of them and they are excellent people and I don't disparage their names at all, but I would hope that there could be a spreading of the knowledge and input throughout all sectors of higher education.

I understand that most of the loans purchased—or a higher percentage of them—are from those types of institutions because they have many graduate students and also higher tuitions.

I would like to address two of the problems that may exacerbate the problem that we just discussed. One is the Options program, which I understand now is going to be discussed at a June 8 hearing, would consolidate loans that a student has from one lender, which exceed $7,500, or from a single lender at $5,000.

My concern is that it would result in greater skimming or creaming of the current loan portfolios, and if Sallie Mae would consolidate these loans—or State agencies, should you decide to also give them consolidation authority—that the lender would be left with even smaller loans in their portfolios. They would be even more inclined not to make loans to short-term students.

The second problem occurs if Congress adopts the proposal of the administration to have a remaining needs test for all students. Again, it is possible that some students below the $30,000 mark would not be eligible for the full $2,500 loan, which would further exacerbate the small loan problem.

I think it is a real problem. I have with me a survey that was done last summer, asking member institutions of AICS if they had any problems with obtaining loans and to what extent was it related to—I used Sallie Mae's policy at that time that the average loan portfolio size or indebtedness would be $4,200 or something like that—and I do have a number of responses which may be instructive to the committee. I would be glad to share that with you.

Mr. SIMON. How lengthy is it?

Mr. CLOHAN. It's three pages.

Mr. SIMON. We will enter that as well as your full statement in the record.

[Prepared statement and survey of William Clohan follows:]

PREPARED STATEMENT OF WILLIAM C. CLOHAN, JR., GENERAL COUNSEL, ASSOCIATION OF INDEPENDENT COLLEGES AND SCHOOLS

EXECUTIVE SUMMARY

1. Sallie Mae plays an important role in providing loan capital liquidity for lenders and state agencies in the GSL program.

2. However, the current federal policy of reimbursing lenders and subsequent purchasers based on the loan size creates a disincentive for financial institutions to make small loans and Sallie Mae to purchase them.

3. Therefore, lenders and Sallie Mae discriminate against students whose aggregate loan amounts are small because they may have low remaining need or because they are enrolled in short-term programs.

4. Many of these students are proprietary school students who come from minority or low-income backgrounds.

5. The federal financial incentives for making and purchasing small student loans should be increased to ensure that lenders and secondary market purchasers are provided comparable incentives for both small and large loans.

Mr. Chairman and members of the Postsecondary Education Subcommittee. My name is William C. Clohan, Jr. and I am General Counsel for the Association of Independent Colleges and Schools [AICS]. Accompanying me is Mr. David S. Shefrin, Chairman of the Board of Directors of Computer Processing Institute [CPI] located in East Hartford, Connecticut and Chairman of the AICS Financial Aid Funding Committee. The Association of Independent Colleges and Schools appreciates the opportunity to present testimony before this Subcommittee on the role of the Student Loan Marketing Association [SLMA or Sallie Mae] in providing secondary market access to lenders who make loans to proprietary school students throughout the country.

The Association of Independent Colleges and Schools represents 570 colleges and schools and over 456,000 students. Approximately 90 percent of the institutions are taxpaying and most provide job skills for careers in business. The Computer Process-

ing Institute enrolls over 6,000 students in five locations in the northeast United States. The Guaranteed Student Loan [GSL] program is vitally important to all AICS institutions. Without adequate access to GSLs, it is doubtful that most AICS institutions could continue to operate.

My testimony will focus on the relationship of Sallie Mae to loan access in the GSL program, identify problems experienced by proprietary school borrowers as a result of Sallie Mae or federal policies, and propose some possible remedies for solving those problems.

Overview of Sallie Mae's role in the GSL program

The GSL program is now mature, having increased almost ten-fold since 1976. The GSL system is complex though, and is based on numerous incentives to lenders, guarantee agencies, and secondary markets. The number of participants in the system makes the lending process precarious and subject to marketplace reactions which often are unexpected by Congress. This fact forces Congress regularly to review the program, particularly since loan access depends primarily on third-party private entities and not government agencies. In the opinion of AICS, the GSL program does need some fine tuning in order to ensure loan access for all potential student borrowers.

Similar to the GSL program, the Student Loan Marketing Association has also matured during the last few years. With that maturity comes the concerns of other participants in the process that Sallie Mae can legally abuse the system through authorities granted it by statute. This concern is heightened by the fact that, unlike the other traditional federal education programs, many members of Congress and their staffs have only limited experience in dealing with education issues from a banking perspective. Winston Churchill once said that the Soviet Union was "a mystery wrapped in a riddle wrapped in an enigma." The same can be said of Congress' perception of Sallie Mae.

Based on an agreement in 1981 with the U.S. Department of the Treasury to discontinue borrowing from the Federal Financing Bank, Sallie Mae has transitioned from the government capital markets to the private capital markets. During this same period, new records on total assets, number of lenders served, and net income and dividends to stockholders were set. In 1982, net income increased 109 percent, dividends increased 39 percent, and assets were 33 percent higher than in the previous year. With this generally agreed upon success, critics have expressed concern that Sallie Mae was perhaps becoming too large and powerful and, more importantly, invading the traditional territory of lenders and state agencies. I believe that these are valid concerns and that they should be reviewed carefully by the Congress.

Sallie Mae has two difficult roles to play. It must balance its mandate to serve a public purpose in the GSL program with its corporate objective of running the private, for-profit entity on a "cost effective basis." This is not always an easy line to walk, and sometimes priorities may differ from those intended by Congress. In testimony by Mr. Edward A. Fox, President and Chief Executive Officer of Sallie Mae, before the Senate Subcommittee on Education, Arts and Humanities last summer, he noted that—

"The thrust and trend of the corporation over the last few years, by Congressional attitude and by necessity, has been to make this a more conservative entity because you have asked us to become a totally private corporation, to finance ourselves in the private capital markets, to break whatever connections that we do have with the Federal Financing Bank and with the Federal Government and to learn to be a self-sufficient entity and taxpaying entity that builds itself on the basis of its balance sheet, its earnings statement, and through its ability to raise capital in support of these programs in the private capital markets without using any tax resources as appropriated by the Congress."

I relate this quote because it has a bearing on the greatest concern AICS has with Sallie Mae and, for that matter, federal policy.

Concerns

In testimony before the National Commission on Student Financial Assistance in January, 1983, Department of Education Comptroller, Ralph Olmo, stated that—

"Lenders and secondary markets alike recognize that small loans cost just as much as large ones to service. And the result is that certain cagetories of students, primarily vocational and college freshmen, are begining to experience difficulties in obtaining loans until they complete their first year of school. When that occurs, the

lender can reasonably anticipate that the borrowers will have a substantial debt by the time they graduate."

He goes on to state that—

"If students cannot get loans until their sophomore year, many of them may never be able to make it through their freshman year. And while not everyone can benefit from a college education, most can benefit from some form of vocational or technical education. Industry needs skilled technicians. Traditionally, students attending vocational schools come from lower-income families and need financial assistance to go to school. As most vocational programs are one or two years in duration, these students will not have sufficient average indebtedness to make lenders or secondary market servicing costs economically viable."

The statement by Comptroller Olmo concisely and forcefully presents the problem experienced by potential proprietary student borrowers. First, lenders can reap higher returns on larger student loans, since it almost costs as much to administer a small loan as it does to handle a large one. However, it should be noted that it costs the government more to subsidize larger loans. A second factor making it difficult for vocational and technical students to obtain GSLs is that lenders generally must have an average loan indebtedness of between $4,200 and $4,800 in their portfolios in order to sell their GSLs at face value or par to Sallie Mae.

The result is that many lenders throughout the country have established policies which discriminate against short-term course students, most of which are concentrated in the proprietary and community college sectors. For example, Chase Manhattan Bank, one of the largest lenders in the GSL program, refuses to make loans to students in courses of less than two years in length. Until recently, Chase Manhattan was holding their loans through the entire collection period. Recently they have sought to sell them to Sallie Mae and, therefore, must consider Sallie Mae's unpublished requirement that average loan indebtedness must be significantly high to provide an adequate return to Sallie Mae.

The effect of secondary market policies are subtle and difficult to quantify. However, in our discussions with lending institutions which have decided to terminate lending to short-term course students, we have been informed that Sallie Mae's policy is a primary consideration in eliminating lending to small-loan borrowers. Last summer, AICS queried its membership to determine if the average loan indebtedness requirement of Sallie Mae inhibited lending to their students. The responses identified geographically scattered problems. Although this was not a scientific survey, it does represent problems which should be dealt with by Sallie Mae and the Congress. For that reason, with the Subcommittee's permission, I would like to enter a summary of that survey in the record as a part of my testimony.

In addition to not lending to certain types of students, other financial institutions will only make loans which exceed a certain minimum amount. Last year Sallie Mae prepared a list of representative lending institutions which had a minimum loan size requirement. I ask that this list also be made a part of the hearing record.

As a part of Sallie Mae's student loan pricing overview in 1982, it identified the variables it considers in pricing loan portfolios. The pricing overview identified several seller-influenced characteristics of most critical importance to the value and price of a portfolio. One of these was average loan indebtedness. Sallie Mae suggests to a lending institution who seeks to sell their portfolios to Sallie Mae, that they remove lower indebtedness freshmen, sophomore and junior loans, and add higher indebtedness sophomore and junior loans. The 1982 SLMA pricing overview goes on to note that "the major causal factor that underlies the importance of loan size is the impact of servicing costs on the yield of a student loan. Whether these costs are paid by SLMA to a contract servicer or incurred by its in-house facility, each loan incurs and absolute dollar cost for each month it must be serviced, regardless of its size." Herein lies the greatest problem with the current federal policy with respect to subsidization of administrative costs for GSLs.

Sallie Mae's pricing policy reflects the fact that the direct servicing cost associated with a student loan are the same, in terms of dollars per loan, small or large. For this reason a larger loan has more value that a smaller loan. As loan size increases, dollars of net income increase, but direct dollar servicing costs remain constant. The SLMA pricing overview goes on to state that—

"While the exact figures may differ somewhat, these cost factors are the same faced by any lender and force anyone not willing to lose money to restrict small loan activity. This fact has been recognized by financial institutions that originate student loans. These institutions restrict lending in small amounts not only for students, but for all types of consumer loans."

As noted earlier in the testimony, Sallie Mae must show a solid "bottom line" in order to be attractive in the private capital market. Therefore, they must make fi-

nancial pricing decisions which will enhance that financial creditworthiness. One way of doing this is to pay a price of par for an interim loan only if the average borrower indebtedness for a loan portfollo is at least $4,200. To many lenders and guarantee agencies, a $4,200 average indebtedness to qualify for par purchase may be totally unreasonable and, in some cases, unattainable. Their alternative is to sell the loans to Sallie Mae at a substantial discount or adopt a minimum loan requirement at the lending level. The result of this minimum requirement would be that some students would borrow more than they really need or want to borrow or other students would not be able to borrow at all.

This dilemma is exacerbated by the recent adoption by the Congress of the requirement that need be determined for all borrowers with family incomes exceeding $30,000. If Congress were to require a need determination for all student borrowers, the average loan size would probably decrease and the average loan indebtedness requirement established by Sallie Mae would have an even greater adverse effect.

In summary, Sallie Mae policies regarding loan purchases have, if you will excuse the expression, a "trickle down" effect on lenders. Using sound financial and business practices, a lender will be much less likely to lend to a student whose fixed costs are quite high in proportion to the amount of the loan principal. This leads to "skimming" the best loans. If you ask lenders if they engage in such a practice, most will readily admit to doing so based on pure economic reasons.

Remedies

A constructive criticism of Sallie Mae's average borrower indebtedness policy is really a criticism of the current federal policy. The GSL program has a built-in bias toward large loans. This increases the total GSL program costs and inhibits lending to students attending short-term courses or students who want to borrow small amounts. Federal policy should recognize the economies of scale inherent in making, administering, and collecting large loans. Much of the cost to lenders and secondary market purchasers occurs when the loan is made and when the loan is in repayment or collection status. These costs are relatively comparable for both large and small loans, therefore, the federal subsidy for making large and small loans ought to be comparable to the costs of making, administering, and collecting on those loans.

One important point that is often overlooked when evaluating the costs of the GSL program is that, because repayment begins earlier, the in-school interest subsidy paid by the federal government is much smaller on those loans made to students attending short-term courses. Students attending four-year or greater programs are much more highly subsidized than proprietary school students. This is significant because the in-school interest subsidy is a primary cost of the GSL program. As noted in the National Commission on Student Financial Assistance Report entitled "Study Of The Costs To Borrowers Of Participating In The Guaranteed Student Loan Program:"

"The total federal subsidy (i.e., interest subsidy and special allowance) is structured to provide the most benefit to student borrowers attending high cost institutions, attending four-year institutions, and acquiring postgraduate educations. This occurs because the subsidy is highest when the maximum amount is borrowed and repayment is delayed as long as possible."

The Association of Independent Colleges and Schools recommends consideration of the following for dealing with the small loan size problem by increasing the incentive to lenders to make small loans and secondary markets to purchase these loans.

1. Increase the special allowance as the size of the loan decreases to recognize the basic fixed costs inherent in making all loans, small and large.
2. Pay an origination fee to the lender which would be larger for small loans at the time of origination.
3. Make a supplemental payment to the secondary market purchaser on the total loan portfolio for portfolios with smaller than some specified average loan size.

Although these proposals may cost the government slightly more initially than under the current policy it is possible that the total GSL program cost will decrease eventually because lenders will not have as great a disincentive to make small loans. Thus, the very expensive aggregate in-school interest subsidy paid by the government may go down because the amounts borrowed would decrease.

Summary

Sallie Mae is a for-profit corporation which needs to use good business practices to remain viable and compete in the private capital markets. At the same time, it must remember its public policy objectives mandated in its statutory charter. Built into the current GSL program are incentives for both Sallie Mae and lenders to dis-

criminate against borrowers seeking small loans. The incentives in the program should be changed to ensure that it is equally advantageous for a lender to lend to a student who seeks a small loan as it is for those who are going to borrow large amounts over a long period of time. The easiest way to create such equality is to establish a supplemental special allowance for lending to persons seeking small or few loans.

EXHIBIT V.—*Minimum loan sizes*

Institution:	*Dollar amount*
American Security (D.C.)	1,500
Chase Manhattan Bank (N.Y.)	3,000
Chemical Bank (N.Y.)	2,000
Citibank (N.Y.)	2,000
Fedility Bank (Pa.)	1,500
First American (D.C.)	1,500
First and Merchants National Bank (D.C.)	1,500
First Pennsylvania (Pa.)	1,500
Marine Midland (N.Y.)	1,500
Mellon Bank (Pa.)	800
Provident Bank (Pa.)	2,500
Riggs (D.C.)	1,000
Average	1,692

Question 7-C. Are you aware of any discrimination against proprietary institution students? If so, how is that discrimination evidenced by the Student Loan Marketing Association (Sallie Mae)?

"Yes, packaging of loan—banks can't package proprietary loans and sell them."—Arizona.

"Just in total volume required to do business."—California

"I have always been aware that Sallie Mae has only purchased large portfolios and understand why."—Florida.

"Requirement of Sallie Mae for banks to have a large portfolio, when typically proprietary students have only one loan."—Illinois.

"One lender will only take students in two-year programs so they will have enough to sell off to Sallie Mae—excludes any students under two-year programs."—Kansas.

"All three (financial institutions, state loan/guarantee agencies, and Sallie Mae) favor students expecting more than 9 months of loan need."—Kansas.

"Only with regard to size of portfolio."—Maryland.

"Yes—Sallie Mae makes it difficult to sell small, proprietary student loans to them."—Maryland.

"Average loan in portfolio must average $4200."—Michigan.

"Yes, limiting portfolio amount to $4200 instead of $1000 or $2500."—Missouri.

"According to lending institutions which we previously had students apply to, Sallie Mae would not purchase their portfolios due to the low average balance of the loans."—New Mexico.

"Local banks who sell to Sallie Mae will not process our loans because total debt per student is not enough."—North Dakota.

"Maximum portfolio is $4500 to $5000."—West Virginia.

"Maryland banks say they have difficulty selling one-year portfolios to Sallie Mae and will not loan to our one-year students."—Maryland/Virginia.

"Average loan size required in the financial institution's portfolio."—Michigan.

"Package size."—California.

Yes."—California.

Yes."—California.

Yes."—Georgia.

Yes."—Louisiana.

"Fortunately, our bank is not interested in Sallie [illegible]'—Louisiana.

"Do not understand this organization."—Alabama.

Question 9. Are you aware of any requirements by Sallie Mae which inhibit lenders from making loans to your students, e.g., average loan portfolio size purchase requirement is too high?

"All Maryland banks except Union Trust will not loan to one-year schools due to Sallie Mae needs two year portfolios."—Maryland/Virginia.

"Yes, this will be a problem soon and banks have told us this."—Arizona.

"Yes, $4500 to $5000—one year student—difficult."—West Virginia.

"Yes, self lenders."—California.
"Yes—average loan portfolio size purchase requirement is too high."—California.
"Yes—this is very common."—California.
"$3[illegible]000 gross income as cut off."—California.
"Yes, average loan portfolio size purchase requirement is too high."—California.
"Yes, $2500 is the minimum and maximum loan amount available to our students due to this very factor."—Florida.
"Yes—minimum $4700 portfolio is forcing bank to restrict loans to all but four-year degree seeking students."—Florida.
"There are several lenders which have expressed the size of the loan portfolio as the reason for not being able to make loans or restricting the number of loans"—Illinois.
"Yes. First National Bank of Chicago will not consider our students unless they are in the degree program"—Illinois.
"Yes. Average loan portfolio size purchase requirement is too high"—Kansas.
"Yes. I have been told this by certain bank officials."—Maryland.
"Yes.—$2500 average."—Louisiana.
"Yes. Any less than one-year."—Missouri.
"Yes. $4200 average loan portfolio per student first year (all proprietary students for us) maximum GSL amount is $2500. This is prohibiting lending to proprietary students."—Missouri.
"That has been relayed to us by two banks in the city of Albuquerque."—New Mexico.
"Yes. Loan portfolio too high."—New Jersey.
"Other than this, no!"—California.
"It is not the portfolio size that is too high, but the discount on small loans makes it unattractive for banks to sell the paper."—Texas.
"Yes, average loan portfolio requirements."—Ohio.
"Lenders want students with potential of $4000 loan debt."—North Dakota.
"I believe this is a problem—our students would have maximum loans of $2500."—Michigan.
"We understand that this is a problem, but have no first-hand information."—Ohio.
"We are aware of it, but has not directly affected our students."—Texas.
"I am not aware of any requirements by Sallie Mae but I have been told by banks that they do not want to make loans to our students because the size of the loan is too small."—Virginia
"I have only heard about the portfolio size."—Virginia.
"Heard rumor of such at NASFAA annual meeting in Detroit but I don't know details. I have no personal experience with any limitations.."—Wisconsin.
"Have heard those indications but have no first hand knowledge."—Kentucky.
"We have no direct knowledge of this but have heard from other schools that it is a problem."—Illinois.
"I've heard this is true."—California.
"Do not know the requirements and have found the bankers do not know.."—Alabama.
"Our loan service not interested in Sallie Mae at this time."—Louisiana.
"Only by current media information."—California.
"Yes."—California.
"Yes."—California.
"Yes."—Pennsylvania.
"Yes."—Louisiana.
"Yes."—Maryland.
"Yes."—Kansas.
"Yes."—Georgia.
"Yes."—Connecticut.
"Yes."—Michigan

Question 10. Are you aware of any activities by Sallie Mae which have enhanced lending to or loan consolidation by your students. If so, what are they?

"Yolanda Fleming visiting West Virginia to sell banks on Sallie Mae."—West Virginia.
"Yes, if they would continue to accept our small loans."--Michigan.

Mr. CLOHAN. The other thing I have—it came from Sallie Mae's 1982 overview of pricing policies—a list of representative institutions that have minimum loan requirements. In other words, they

will not make loans of less than a certain amount, and this is a problem that many of our students run into.

It points out the need perhaps for the GSL program to provide additional incentives to make smaller loans. It is my feeling that it may be possible that the total costs of the GSL program in the Federal Government may go down, if this small additional supplemental allowance is paid, because students won't feel compelled to borrow the entire $2,500. Lenders won't feel compelled to make the largest loans they can just to increase the portfolio or get the average up enough in order to sell it to Sallie Mae.

That completes my testimony.

Thank you.

Mr. SIMON. Thank you very much. You touched on a point that we were discussing earlier here and that is the smaller loan. I don't, frankly, know if we can do anything on it until we get to the point of reauthorizing.

Have you made any attempts at your three different options of costing out any? You have indicated that one might even save money, though I am a little cautious.

Mr. CLOHAN. I agree. I said "may."

Mr. SIMON. But have you done any cost estimates at all?

Mr. CLOHAN. No, I haven't because it would depend on what type of incentives you provided. If you gave a lender an additional 25 or 50 basis points, which is a percentage of a percent, it's hard to tell what the reaction of the lenders would be. That's one of the problems with this program is that it depends on the desire of the lender or the response of the lender, the carrot-stick approach to adding a little bit of special allowance. It also is a function of what alternative sources do they have to make loans, other types of consumer lending.

The special allowance in this program was over 12 percent and the prime rate was up around 20 percent, this was a very attractive program because nobody would borrow 16 and 18 percent money to purchase a house. Now when it's down to around 10 percent or the entire cost and special allowance is below 5 percent, there are a lot of other types of consumer lending that are, frankly, as attractive, if not more so, and I think, as Chase Manhattan will point out in their testimony later, there is a need on the part of the corporate executives to balance their portfolios, their lending so that it's not all, only, in the student aid area.

I would suggest, if I could, that perhaps it would be worth getting the Congressional Budget Office to do maybe some modeling of what the response would be and the cost would be.

Mr. SIMON. A good suggestion. Then, one final question.

You mentioned banks having minimum amounts. Can you give me some fairly typical examples of this?

Mr. CLOHAN. Yes, in the pricing overview by Sallie Mae, they list several banks. These were effective July 1982 and they may have changed somewhat.

American Security here in Washington, $1,500. Fidelity Bank in Pennsylvania, $1,500. First American here in D.C., $1,500. Chase Manhattan at the time had a $3,000 minimum.

One thing I will point out that Chase, which is one of the largest lenders in the program—I think they are second largest—have a

policy which prohibits lending to any student who is in a program of less than 2 years and in a nondegree program. So basically, they have dropped out of the vocational school lending.

Citibank established the same policy last year and within a couple of weeks reversed their position on it, but I have a list, just in the New York City area alone, of 13 financial institutions who will not make loans to students who are in a nondegree program of less than 2 years. It is very difficult for them to find access to GSL's. I think that is unfortunate because probably 85 percent of them are minorities and come from poverty level families.

Mr. SIMON. Mr. Coleman.

Mr. COLEMAN. I don't have any questions but I thank Bill for coming and for his constructive, actual, realistic suggestions; which is somewhat unusual for a congressional hearing, to actually have something specific to go forward with. I think we need to take a look at that special allowance suggestion.

Thank you.

Mr. SIMON. Mr. Ackerman.

Mr. ACKERMAN. No questions.

Mr. SIMON. Mr. Erlenborn.

Mr. ERLENBORN. Thank you, Mr. Chairman.

Bill, it's good to see you and thank you for your testimony. Tom, I guess Bill has been coming here for so many years that giving constructive suggestions just comes naturally.

Mr. CLOHAN. I would like to say before I take total credit for them that they have been presented in some form at some presentations before the National Commission on Student Financial Assistance so a lot of it was just skimming or creaming that testimony.

Mr. ERLENBORN. In your comment about some institutions having minimums and particularly Chase Manhattan would, under their policy, only deal with those who are in degree-granting programs. Is it proper to assume that every lending institution should have the full range or should we look for a system where you may have some lenders with one policy, other lenders with another, but the range of services or loan amounts can be accommodated within the system rather than by each individual lender?

Mr. CLOHAN. I think the problem of not having loan access for some students raises the more important issue of whether there should be a lender of last resort, either nationally or in each State, or whether some percentage of all lenders, all participants in the GSL program, should have a lender of last resort responsibility. If there were a lender of last resort in New York State or in any other State—the State of Illinois—then it wouldn't be a problem and some State lending-agencies do serve that function.

This is not an entitlement program and there is no primary requirement that there be a lender of last resort in every State.

Sallie Mae does have the authority under the 1980 amendments to come into a State if the State asks and if the Secretary of Education approves. I don't see that happening any time soon even though the State agencies are outwardly concerned about that.

I do think that all institutions in the program have some responsibility for making loans to all types of students. I am not saying that they ought to throw normal business practices and the need to

improve their bottom line to the wind, but I do think they have public responsibilities, just as I think that Sallie Mae even has a greater responsibility to encourage that.

I will say that in 1979, for example, when Arizona had such a problem and I worked with Ed Fox in trying to resolve that problem and Sallie Mae did resolve it. So they are responsive and they don't only look at the average indebtedness. But maybe there ought to be a built-in incentive and then Sallie Mae wouldn't have to deal with the issue.

Mr. ERLENBORN. Do many of the short course institutions have loans available at the institutions themselves?

Mr. CLOHAN. Very few, except they usually have what they would call "a retail installment contract," and technically under almost all State loans it constitutes a loan, and that is, that they pay the tuition over the period of the course. So that, technically under most State laws is a loan. They generally do not make a loan of *x* thousand dollars which must be paid back. The effect is the same though.

Mr. ERLENBORN. Thank you, Bill.

Thank you, Mr. Chairman.

Mr. SIMON. Mr. Gunderson.

Mr. GUNDERSON. Thank you, Mr. Chairman and Mr. Clohan. I have just one question. You mentioned some of the difficulties in obtaining short-term or smaller amount loans, et cetera. If my State of Wisconsin is any example, we have a large number of our independent colleges and universities in rather small communities. I would be interested in knowing if that presents, in your knowledge, a rather special problem—obtaining these loans in the financial institutions in rather small communities? Is the need greater than the ability of the financial institutions to meet?

Mr. CLOHAN. As is pointed out, again, I believe it's in Chase's testimony to come, many banks are only breaking even in this program. Economies of scale help quite a bit and the larger the lending institution, the more likely that they are going to make a profit on the GSL program. The tremendous changes over the past number of years creates a difficulty for a small bank.

And for that reason, in order to break even or make a profit, the smaller financial institution has to take more care in not making loans that are not as profitable. A small loan—there is no doubt about it—is less profitable than a large loan because it costs just as much to make and collect as the large loan, but you have the special allowances received on the principle of the loan itself.

In Wisconsin, I believe I am correct in this, you are one of the States that has perhaps the closest to a lender of last resort, and therefore, in my understanding, there is not a big problem in the State of Wisconsin.

Mr. GUNDERSON. Thank you.

Mr. SIMON. Thank you very much. We appreciate your being here.

Finally our panel, and my apologies for almost forgetting about you, Peter Solomon, Frederick Hammer, and Geoffrey Hurley.

Mr. Solomon is the managing director of Lehman Brothers. Mr. Hammer is the executive vice president of the Chase Manhattan Bank and Mr. Hurley is with Brownwood, Ivey, Mitchell & Petty.

We will hear from all three before we ask questions of you.
Mr. Solomon?
[Prepared statement of Peter Solomon follows:]

PREPARED STATEMENT OF PETER SOLOMON, MANAGING DIRECTOR, LEHMAN BROTHERS KUHN LOEB, INC.

INTRODUCTORY REMARKS

Lehman Brothers and Sallie Mae have periodically worked closely together since Sallie Mae's inception in 1973. Lehman Brothers is very proud of and honored by its relationship with Sallie Mae. Sallie Mae is an extremely well structured financial institution that is effectively accomplishing the goals established in its Congressional charter. In ten years it has successfully managed phenomenal growth and is now an $8 billion corporation. The corporation's assets have doubled in the last two years, and yet, this growth has not jeopardized the financial integrity of the corporation. Conservative financial management has produced consistent increases in net income despite the gyration of interest rates. Net income rose over the last five years from $5.9 million in 1978 to $37.8 million in 1982. This has been accomplished while Sallie Mae incurred federal corporate income tax liability in the last five years of $65 million.

INITIAL CAPITALIZATION AND FUNDING

A year after Sallie Mae's creation, the capital base for the corporation was laid. Lehman Brothers was the lead manager in the common stock issue of May 1974 when 166,776 shares were sold at $150 per share. Sallie Mae's enabling legislation restricted holders of its common stock to financial and educational institutions that could be active in the Guaranteed Student Loan Program. This provision is still in effect. Approximately 75 percent of the shares are held by financial institutions, and the remaining 25 percent are held by educational institutions.

On March 31, 1981, Sallie Mae's common stock was split six-for-one. The one million shares outstanding have appreciated from their original price of $25 per share to $40 per share. Given the dramatic growth in assets, earnings and the near perfect balance between the corporation's assets and liabilities, the stock has the potential for substantial further appreciation. Bank of America and the First National Bank of Chicago make a secondary market in the stock.

Dividends on this stock were paid for the first time in 1977 and have been consistently increased each year from $.25 per share in 1977 to $2.13 in 1982. These modest payments have enabled Sallie Mae to retain a large portion of its earnings to support its rapid pace of growth.

Sallie Mae initially financed its student loan program assets with discount notes sold in the credit market through the Federal Reserve Bank of New York as fiscal agent. The $400 million of three-month and six-month notes had the full faith and credit guarantee of the U.S. government which the enabling legislation provided. This debut into the public markets was successful. However, in 1974, with the creation of the Federal Financing Bank [FFB], Sallie Mae was required to issue its debt securities solely to the FFB under the terms and conditions established by the FFB and the Treasury. From 1974 to 1981 the Federal Financing Bank provided all of Sallie Mae's financing needs. This secure source of financing was originally provided at ⅜ percent and ultimately ⅛ percent over the Treasury's cost of debt. These funds allowed the corporation to purchase guaranteed student loans from originators and to make loans (warehousing advances) to institutions that lend in the guaranteed student loan program. These warehousing advances utilized guaranteed student loans as collateral.

Since both the student loans and the variable-rate warehousing advances yields are tied to the 91-day Treasury bill, as is the FFB debt, the corporation built a solid balance sheet, and consequently was able to provide its services at attractive prices.

Originally the majority of this debt held by the FFB had short maturities. Beginning in November 1980, Sallie Mae began converting this debt into longer-term, variable rate notes. These notes more closely match the maturity of the corporation's student loan assets.

In March 1981, consistent with the Administration's desires, Sallie Mae accelerated the plan previously intended by both Congress and Sallie Mae to utilize the public credit markets to meet its financing needs. It was agreed that Sallie Mae would discontinue further FFB borrowing when the outstanding debt reached $5 billion or by September 30, 1982. Sallie Mae is the only entity to make the transition

from the FFB to the public credit market. Sallie Mae also agreed not to use the full faith and credit status available through September 30, 1984. The final $400 million of the $5 billion FFB debt was drawn in January 1982.

DEBT AND EQUITY MARKETS REENTRY

As Sallie Mae made its egress from the FFB, it closed one door and opened another as it began issuing its first debt in the private markets. The corporation faced new challenges, risks, and considerations. It no longer had ready access to credit at ⅛ percentage point over the Treasury yield curve throughout the interest rate cycle. Although Sallie Mae's balance sheet and income statement told an exciting, promising story, the perception that investors held about an institution involved in student loans presented a challenging communication problem. The publicity about the high level of student loan defaults created visions of huge loan losses in the minds of many potential investors.

In order to issue debt cost effectively, Sallie Mae had to continue managing its affairs conservatively. Financial analysts and potential investors would be dissecting its financial position and pricing its debt accordingly. Sallie Mae could only continue to offer its services at competitive prices if it could access the markets as a premier credit. This implied a need for steady asset and earnings growth, a balance in maturities of assets and liabilities, the simultaneous repricing of its assets and liabilities, and a need to manage its leverage.

The period between March 1981 and January 1982 provided Sallie Mae the time to execute a smooth transition into the public market place. Investors realized the underlying strength in Sallie Mae's balance sheet, and its securities were quickly accepted at yields comparable to other agencies.

A discount note program was reestablished in May 1981. Discount notes acquainted the capital markets with Sallie Mae and provided the corporation with liquidity. These notes are short-term securities which mature in one year or less. Sallie Mae has generally emphasized the shorter end of this range. The average balance of discount notes outstanding in 1981 was $281 million with an average maturity of 15 days. The program grew in 1982 to an average of $519 million outstanding with an average maturity of 25 days. Presently, less than $100 million are outstanding.

This program received good investor acceptance, and Sallie Mae's discount notes have sold at the same prices as those of other agencies for the same maturity.

During 1981 Sallie Mae's innovative talents were invested in the design of a floating-rate note. Given the variable rate on its program assets, traditional intermediate-or long-term, fixed-rate liabilities were inappropriate for Sallie Mae. If Sallie Mae were to continue to avoid the dangers of reinvestment, refinancing, and basis risk, it had to create new intermediate-term, floating-rate liabilities. The results of these efforts produced an instrument that matched the program assets and had a broad investor appeal. The floating-rate notes have:

(1) A coupon which is reset weekly, and

(2) The coupon is tied to the 91-day Treasury bill auction yield on a bond equivalent basis.

The first floating-rate notes were sold in February 1982. Initially, a $200 million issue was planned, but investor demand was so strong that the amount was increased to $250 million. This three-year note has a rate of interest which is set at 75 basis points over the 91-day Treasury auction yield. The issue was an unwritten offering and was the first floating-rate note publicy offered in the agency market and the first such security offered to the investing public.

Although variable-rate notes had been previously sold, investors had been disappointed with their performance. Their coupons had been reset every three or six months, which was insufficient to protect the principal invested in a volatile interest rate environment. The weekly reset was so popular that within weeks of the February issue it had been copied by several other major institutions.

Sallie Mae sold, in March 1982, a seven-year floating-rate note with the same structure and spread as the previous note, for an additional $200 million. Although both of these issues were very sucessful, the spread of 75 basis points was significantly higher than the cost of the FFB debt. This instrument was intended to be a standard financing tool for the corporation; however, it increased the corporation's cost of funds.

The late spring bond rally of 1982 decreased the attractiveness of the floating-rate notes for investors. In a declining interest rate environment, many investors sought fixed-rate securities which "locked in" a yield or resulted in capital gains. The potential cost of issuing additional floaters rose, and the corporation sought alternative sources of long-term funds.

The urgency to acquire term funds mounted as September 30, 1982, approached and the legislation dealing with paru passu had not been passed. Should the corporation have to offer subordinated debt, the costs would be significantly higher. In many market environments, it could result in Sallie Mae pricing its services at uncompetitive levels. Sallie Mae, under these circumstances, would be significantly hampered in meeting the goals set forth in its charter.

Discount notes were an important source of liquidity at this time. As of September 30, 1982, Sallie Mae had $941 million of discount notes outstanding, over three times the average 1981 balance. Maturities were lengthened; the average maturity of discount notes issued in September rose to 66 days. Discount notes provide an excellent means of acquiring short-term funds when needed.

In the search for additional financing, Sallie Mae sold $200 million of floating-rate notes which were privately placed and will mature on September 28, 1983, with an annual extendable maturity through 1987. The rate on these notes was also 75 basis points over the Treasury bill. An additional $100 million was acquired via master notes. These notes are due on demand and have a maximum maturity of nine months. The cost is tied to the certificate-of-deposit equivalent of the 91-day Treasury bill auction rate, a very attractive price.

In the summer of 1982, the corporation began analyzing a new technique used in the Eurobond market to transform fixed-rate liabilities into floating-rate liabilities and vice versa. Sallie Mae continued its innovative tradition and adapted this mechanism, the interest rate swap, for domestic markets.

An interest rate swap involves no transfer of principal. Sallie Mae agrees to make periodic floating-rate payments to a counterparty, and the counterparty agrees to make fixed-rate payments to Sallie Mae. Sallie Mae issues fixed-rate debt and converts it into the intermediate-term, floating-rate debt it desires via this mechanism. Lehman Brothers was pleased to provide Sallie Mae with its first swap counterparty and to arrange a fixed-rate, intermediate-term debt issue to finance it. Sallie Mae is now issuing its debt as a fiscal agency.

Floating-rate notes have recently augmented the financing offered via interest rate swaps. The money market accounts, authorized for banks and thrifts in December 1982, have recently generated additional demand for floating-rate notes. The billions of dollars flowing into these accounts can be invested in floating-rate notes with minimal basis risk. The deposit and the FRNs are repriced weekly.

Sallie Mae took advantage of this increased demand by issuing $200 million of floating-rate notes in April 1983. The robust demand for this type of instrument allowed Sallie Mae to price this issue at 35 basis points over the 91-day Treasury bill with a term to maturity of ten years.

Since Sallie Mae ventured into the capital markets in 1981, new creative debt instruments have been designed and utilized by the corporation to finance the ever-growing demands to assist in the funding of higher education. Sallie Mae has responded adroitly to the rapidly changing environment.

The tradition established with its debt instruments was maintained in its equity offering In February 1983 when it issued five million shares, at a price of $50 per share, of adjustable rate cumulative preferred stock [ARP]. An ARP was first offered by Chemical Bank in May 1982. At that time the cost of this type of equity was quite high and was unattractive to Sallie Mae. With the compression of spread relationships in the winter, this instrument became more and more appealing.

At the end of last year, Sallie Mae had a debt-to-equity ratio of 72 to 1. Investors were not overly concerned about their risks given the extremely well-matched balance sheet. The government guarantees on student loans and the collateral provided on the program assets minimize credit risk. However, this extremely high leverage ratio could have become a constraint to further growth, and acquiring additional equity was desirable.

The ARP provided inexpensive attractive capital. Its advantages include:

(1) the dividend is reset quarterly and is equal to 4.5 percentage points less than the highest of the 91-day Treasury bill rate, the 10-year Treasury constant maturity rate and the 20-year Treasury constant maturity rate;

(2) the dividend can be no greater than 14 percent; and

(3) there is a three-year call provision.

A 9 percent dividend is offered through June 30, 1983, and there is a floor of 5 percent.

The timing and pricing of this issue was optimal. Pricing of ARPs improved until the week of Sallie Mae's issue and deteriorated within a week after this issue.

The $250 million of equity provided significantly decreased the corporation's leverage. The debt-to-equity ratio in March dropped to 20 to 1. This is now comparable

to the nation's major financial institutions' leverage positions. A lower debt-to-equity provides Sallie Mae with greater flexibility to acquire more program assets and to design less traditional program assets.

Sallie Mae's financial history has been dominated by two phenomena:

(1) Prudent, conservative asset-liability management, and

(2) Innovation.

These are enviable characteristics that more financial institutions should emulate. Sallie Mae is an outstanding corporation that seems to be creatively fulfilling the goals of its charter. Moreover, in its reentry into the market, Sallie Mae has gained the respect of Wall Street for its ingenuity, integrity, and operating ability.

CONCLUSION

In summary, this corporation has built a solid foundation upon which it should be able to provide additional support for higher education finance. In a very short period of time, these resourceful managers have developed three major and reliable funding sources that are complementary in nature and should provide funds at reasonable cost throughout the interest rate cycle. The stability of Sallie Mae's balance sheet and the continuity of its earnings, combined with its prospects for the future, all provide a marvelous story for a person in my business to tell investors.

STATEMENT OF PETER SOLOMON, MANAGING DIRECTOR, LEHMAN BROTHERS, KUHN, LOEB, INC.

Mr. SOLOMON. Thank you, Mr. Chairman. It's an honor to appear before the Subcommittee on Postsecondary Education and to present my views on the investment banking community's perception of Sallie Mae.

I have submitted to the record a longer statement, which details Sallie Mae's financing history and its recent entry into the public debt preferred equity market.

Let me confine my remarks to two points. First, the critical role that Sallie Mae plays in the success of the student loan programs, and second, the importance of the financial market's perception of Sallie Mae's high credit quality, to Sallie Mae's ability to meet the public purposes outlined for it by Congress.

With respect to the student loan programs, it is clear that the availability of Sallie Mae's services is a major contributor to the willingness of financial and education institutions to make student loans.

Without Sallie Mae's willingness to purchase and service student loans made by these institutions and without Sallie Mae's advances to these institutions so that they can make loans, we would see considerably fewer student loans made in our Nation and at considerably higher costs.

I hold these views based on my experience providing investment banking services to many financial institutions over the years and to my current position as an overseer of Harvard University.

On the second issue there is no doubt that Sallie Mae's ability to sell debt at reasonable interest rates and on a regular basis is central to its ability to purchase student loans and to make advances to lenders which make student loans.

Sallie Mae's securities currently are perceived by the financial markets as very high quality securities comparable in quality to the best Government agencies' securities such as the Farm Credit Administration.

In my business, all debt securities are priced relative to Treasury bills, which, of course, are the highest quality taxable bonds. We now sell Sallie Mae's securities at yields which are approximately

25 to 30 basis points, or one-fourth to three-tenths of a percent of an interest percent, higher than the yield on Treasury securities.

I should note two things. First that as a point of reference, this rate is better than the rate on triple A quality commercial banks. Second, this is probably a cyclical low. The two issues of floating rate notes which were done by Sallie Mae in 1982 were at spreads of 75 basis points above the T-bill rate. That Sallie Mae is perceived as such a high quality company is a credit to the company's prudent management and to the superb job that Ed Fox and his group have done in educating the financial community about Sallie Mae.

After all, we should not forget that the reactions of both investors and bond salesmen the first time they heard the name "Student Loan Marketing Association," was to think of students defaulting on loans, which, as you can imagine, is not the best thought when one is trying to borrow money for Sallie Mae in large magnitudes at the lowest possible interest rate.

I thought it would be of interest to the committee if I could summarize how Lehman Brothers sells Sallie Mae bonds to the public and what facts about Sallie Mae's securities are important to investors.

First, it is extremely important to investors that they are buying the most senior, first priority in terms of bankruptcy, securities of Sallie Mae. Bondholders want complete assurance that, in the event of bankruptcy, their claims would be equal to the claims of other creditors. That is why investors generally buy subordinated debt at rates that are often 50 to 100 basis points or more above the interest rate on senior debt.

For Sallie Mae marketing its publicly sold securities subordinated to the FFB debt, would have an additional chilling effect because investors would perceive rightly or wrongly that the Government was washing its hands of the responsibility for Sallie Mae and this, of course, would mean higher rates of borrowing for Sallie Mae.

The second critical point in selling Sallie Mae's bonds is the perceived ties that Sallie Mae has to the Federal Government. The fact that Sallie Mae's assets are federally guaranteed, the fact that Sallie Mae has a $1 billion line of credit from the Treasury, although it has never been used, the fact that Sallie Mae has $5 billion of borrowings from the Federal Financing Bank and the fact that Sallie Mae's securities are exempt from State and local taxation all contribute to the perception that Sallie Mae is an agency security.

Without this perception, Sallie Mae's borrowings would be considerably more expensive.

Third, Sallie Mae borrows on attractive terms because it is a conservatively and creatively managed company which almost perfectly matches the maturity and pricing of its assets and liabilities. Through sound and creative management, Sallie Mae has avoided the gap which many other financial institutions fell into—providing short-term and lending long-term or borrowing long-term and lending short-term.

One need only look at the savings and loan industry to see the problems that this could create.

Finally, the fact that Sallie Mae's profitability has grown in recent years provides assurance to investors that the company is generating enough income to meet its interest and other expenses. The importance of all this is really quite simple.

If Sallie Mae can borrow at low interest rates in the public markets, it can grow more rapidly and ultimately facilitate loans to students at more attractive terms.

In my judgment, the legislation that you are looking at is essential to allowing Sallie Mae to continue to play this role.

Thank you, Mr. Chairman.

Mr. SIMON. Thank you for a statement that was so good it sounds like it was written by Sallie Mae.

Our next witness, Mr. Frederick Hammer, executive vice president of Chase Manhattan.

[Prepared statement of Frederick Hammer follows:]

PREPARED STATEMENT OF FREDERICK S. HAMMER, EXECUTIVE VICE PRESIDENT, THE CHASE MANHATTAN BANK, N.A.

Mr. Chairman and distinguished members of the Subcommittee. My name is Frederick S. Hammer. I am Executive Vice President of the Chase Manhattan Bank, with responsibility for the Consumer Banking Sector. It is a pleasure to appear before you today to discuss the role and significance of the Student Loan Marketing Association. I am particularly pleased to have the opportunity of presenting the viewpoint of the student loan originator because from our perspective, Sallie Mae is not only an exceptionally well managed corporation, but a critical factor in the student loan market.

You have requested that I focus on the importance of Sallie Mae to the Guaranteed Student Loan secondary market in terms of providing "support to lenders." I would like to modify that slightly and discuss how Sallie Mae provides encouragement to lenders, in helping to ensure a consistent market stimulus to originating student loans and facilitating student loan operations. First of all, however, allow me to briefly describe our activities in that market.

Chase has rapidly expanded its student loan business over the last several years. Originations grew at a compound rate of 32.1 percent between 1979 and 1982, from $78 Million to $180 Million, representing by year-end 1982 just under 3 percent of total originations. At that time, Chase had $895 Million in outstanding loans to 225,000 student borrowers, or about 3.3 percent of total outstandings. We make student loans in all 50 states, originating them through direct participation in the Loan Guarantee programs of New York, California, Maryland, Missouri, Arizona and Hawaii, and in other states through the United Student Aid Funds Reserve Program. Chase was also the first lender to participate in the Health Education Assistance loans [HEAL] program, providing assistance to medical, dental, veterinary, and other health career students. We remain the major participant in this program, having originated over 65 percent of such loans by the end of 1982.

Overall, then, as the second largest lender in the country, Chase has demonstrated consistent leadership in the student loan market. And as a lending lender, we believe that Sallie Mae performs a critical and highly constructive role in providing a healthy stimulus to our ability to perform effectively as a business in that market. Let me elaborate briefly.

I earlier made the distinction between Sallie Mae "supporting" and "encouraging" lenders because, as you know, Sallie Mae is a private, for-profit corporation; and so, of course, are we! This is important to keep in mind because it determines the context of student loan origination, reinvestment and funding insofar as Sallie Mae is concerned. For Chase, student loans are considered a consumer banking product. We are organized for student lending as a line of business, and the business is measured by how well it performs against standard measures used for other bank products. The student loan division therefore competes for resources and funds with other consumer loan products; and the cost of funds is the major cost element in the business.

The pricing of Sallie Mae "warehousing advances," for example (i.e., advances to lenders collateralized with lenders' student loans) uses as its starting point the same average 91-day Treasury bill yield which is the basis for calculating the "special allowance" paid on student loans by the Department of Education. Sallie Mae adjusts

upward from that base to charge a commercially justifiable rate for its funds. The resultant spread between our cost of funds—including these advances—and our income on the student loan business is sufficiently attractive at the margin to maintain our commitment to the market. At the same time, it is relatively modest compared to other lines of consumer business, and the cost of funds received drom Sallie Mae is, as mentioned, at strictly commercial and arm's length levels. Likewise, our sales of student loans to Sallie Mae help us to manage our business—for example, by controlling or reducing excessive concentrations in given areas or programs. As the largest player in the secondary market, Sallie Mae plays a significant role in enabling lenders to achieve their liquidity and portfolio management objectives; but again, the terms of these sales are commercial.

However, at the same time as Sallie Mae operates on a strictly commercial and arm's-length basis in its relations with lenders, it performs a crucial role in promoting and facilitating our student loan business. It does this by linking the funds it makes available to lenders with conditions that impel us to maintain or increase our student loan originations. Not only are Sallie Mae warehousing advances collaleralized with student loans, but these advances are generally conditioned on reinvestment of funds in additional student loans; or, if market demand and cyclical factors indicate, on maintenance of student loan portfolios at levels existing at the time the new Sallie Mae funds are borrowed. Either way, Sallie Mae warehousing advances provide an essential means of ensuring continuity or even enhancement of student loan activity, both generally and at the margin, by providing a clear incentive to the origination of incremental loans.

Over the last 10 years, Chase has borrowed at various times from Sallie Mae, generally under reinvestment conditions. These funds are a key element of our student loan business and an equally important factor in sustaining our commitment to leadership in that market.

Another way in which Sallie Mae provides encouragement to lenders is by eliminating potential disincentives to entering the student loan market. As the most important single factor in the secondary market, its role is crucial because it allows many banks to remain significant originators where they might otherwise be discouraged from that effort. For a bank to be a full service student lender, it must perform three major processing functions: origination; conversion; and collection. Many banks have elected to avoid the latter two—quite burdensome—processes by selling student loans to Sallie Mae after origination. In the absence of the ability to sell such loans, the prospective high costs of conversion and collection, and the consequent inability to earn an attractive return on the business, would act as a strong deterrent to involvement in the student loan market. For this reason, Sallie Mae's encouragement to lenders can fairly be described as pivotal.

In summary, Sallie Mae has evolved under dynamic and innovative leadership into an institution which successfully combines business performance with the furtherance of critical public goals. We believe that Sallie Mae has contributed substantially to the maintenance of high standards in the industry, and that it has proven to be not only responsible but extremely responsive to the varying needs of lenders and other relevant actors.

We especially welcome Sallie Mae's vocal commitment to supporting state agencies, because these agencies are absolutely key to the growth of higher education opportunity is this country. Since student loans are essentially state programs, and with greater emphasis than ever before on state and local responsibilities for education, it is evident that the student loan market can only benefit from the presence of vigorous actors at both the federal and state levels.

The market itself, as I have indicated, is an attractive one, but it does have an unmet need at the federal level which might warrant additional Congressional attention, and which this subcommittee may wish to address in view of its interest in encouraging student loans. I refer to the need for greater legislative continuity.

As you know, student loans are already extremely complex, due to the involvement of numerous intermediaries and to considerable variegation among state regulations and requirements. The operational burdens involved in this complexity are to a certain extent unavoidable, although they are obviously more onerous for lenders which operate on a multistate level than for institutions lending within only one state. In addition, banking is a very narrow margin business. A successful bank makes less than 1 percent return or assets; therefore, if it loses money on one loan, it must make 100 other good ones just to break even. This is a major reason why bankers abhor uncertainty; the profit margins of the business are simply too thin to afford the luxury of "playing it by ear." Under these circumstances, any aggravation of existing market uncertainties provides a strong disincentive to doing business.

For this reason, frequent legislative change can play a major role in discouraging prospective lenders, especially when the high level of uncertainty created by such change requires resolution within tight timeframes dictated by a business' seasonal nature. This has been the case with regard to student loans almost every year since 1965; and, without taking issue with various substantive changes that have been legislated, I would say that the net result of this heightened uncertainty is a message to prospective lenders not to enter the business. With all due respect, this would appear to be quite the opposite of what Congress has intended, and I would therefore imagine that a plea for greater continuity in legislation and regulation is appropriate. Controlling the trend to excessive procedural modification—taking more on an "if it ain't broke don't fix it" approach— might well encourage greater participation is student loans, while permitting existing lenders to maintain their operational efficiency.

Needless to say, the ultimate beneficiaries of the positive market factors I have mentioned, and of any procedural improvements that might be undertaken, will be those students who are trying to make equal opportunity a reality, and who must receive an appropriate education to do so. In 1965, the average cost of a four-year private university education for a full-time resident student was $8,800. Today, it is $30,000. The need for student loans remains substantial, and can be expected to increase further. It is a market to which Chase in committed and in which we intend to remain leaders. As for Sallie Mae, we strongly believe that both its fundamental mission and its performance against that mission represent critical positive factors in that market—a market on which, in very real terms, our country's future depends.

STATEMENT OF FREDERICK HAMMER, EXECUTIVE VICE PRESIDENT, CHASE MANHATTAN BANK

Mr. HAMMER. Thank you, Mr. Chairman. My name is Frederick Hammer. I am executive vice president of Chase Manhattan Bank with responsibility for Chase's consumer banking businesses. I am pleased to have the opportunity to present today the viewpoint of a student loan originator and, from our perspective, indicate how Sallie Mae has become a critical factor in the student loan market.

We have been requested to focus on the importance of Sallie Mae in terms of providing support to lenders. I would like to modify that slightly and discuss how Sallie Mae provides encouragement in helping to insure a consistent market stimulus to originating student loans and facilitating student loan operations.

To put my remarks in perspective, let me briefly describe our activities. Student loan originations at Chase have grown at about a 30-percent rate over the last several years, from $78 million to $180 million. We did about a high of $400 million in 1981 and we will do about $300 million this year.

We hold about $900 million in outstanding loans to somewhere over 225,000 student borrowers, which represents a little bit over 3 percent of total outstandings. We make student loans in all 50 States in originating them through direct participation in the loan guarantee programs of 6 States—New York, California, Maryland, Missouri, Arizona, and Hawaii—and in other States through the United Student Aid Fund's reserve program.

We were also the first lender to participate in the HEAL program and remained a major participant in this program, having originated about two-thirds of such loans by the end of 1982.

Overall, then, as one of the very largest makers of student lo in the country, we believe Sallie Mae performs a critical and constructive role in providing a healthy stimulus to our ability to perform effectively as a business in that market.

As you know, Sallie Mae is a private for-profit corporation and so do we attempt to be. This is important to keep in mind because it determines the context of student loan originations, reinvestment, and funding insofar as Sallie Mae is concerned.

At Chase, we consider student loans and consumer banking products and we are organized for student lending as a line of business, and the business is measured by how well it performs against standard measures of profitability used for our other bank businesses.

The student loan division therefore competes for resources and funds with other consumer loan products and the cost of funds is a major cost element in the business. The pricing of Sallie Mae warehousing advances, for example, uses as its starting point the same average 91-day T-bill yield which is the basis for calculating the special allowance paid on student loans by the Department of Education.

Sallie Mae adjusts upward from that base to charge a commercially justificable rate for its fund. The result is spread between our cost of funds, including these advances, and our income on the student loan business, is sufficiently attractive at the margin to maintain our commitment to the market.

At the same time, it is relatively modest compared to other lines of consumer businesses, and the cost of funds received from Sallie Mae is, as mentioned, at strictly commercial and arm's-length levels. Likewise, our sales of student loans to Sallie Mae help us to manage the business, for example, by controlling or reducing excessive concentrations in given areas of programs.

As the largest player in the secondary market, Sallie Mae plays a significant role in enabling lenders to achieve their liquidity in portfolio management objectives, and again, the terms of these sales are commercial. However, at the same time, if Sallie Mae operates on an arm's-length basis in its relations with lenders, it performs a crucial role in promoting and facilitating the student loan business. It does so by linking the funds it makes available with conditions that impel us to maintain or increase our student loan originations.

Not only are Sallie Mae advances collaterized with student loans, but these advances are generally conditioned on reinvestment of funds in additional student loans, or, if market demand and cyclical factors indicate, on maintenance of student loan portfolios at levels existing at the time the new Sallie Mae funds are borrowed.

Either way Sallie Mae warehousing advances provide an essential means of insuring continuity in student loan activities by providing a clear incentive to the origination of incremental loans.

Over the last 10 years, we have borrowed at various times from Sallie Mae, generally under the reinvestment option. By allowing to know our gross spreads in advance, these funds are key elements of our student loan business, and an equally important factor in sustaining our commitment in the market.

Another way in which Sallie Mae provides encouragement to lenders is by eliminating potential disincentives to entering the student loan market. As the most important single factor in the secondary market, its role is crucial because it allows many banks

to remain significant originators where they might otherwise be discouraged from that effort.

For a bank to be a full-service student lender, it must perform three major processing functions: origination, conversion, and collection. Many banks have elected to avoid the latter two, quite burdensome, processes by selling student loans to Sallie Mae after origination. In the absence of the ability to sell such loans, the prospective high costs of conversion and collection, and the consequent inability to earn an attractive return on the business, would act as a strong deterrent to involvement in the student loan market. For this reason, Sallie Mae's encouragement to lenders can fairly be described as pivotal.

In summary, Sallie Mae has evolved under dynamic and innovative leadership into an institution which successfully combines business performance with the furtherance of critical public goals. We believe it has contributed substantially to the maintenance of high standards in the industry and that it has proven to be not only responsible but extremely responsive to the varying needs of lenders and other relevant participants in the market.

We especially welcome their vocal commitment to supporting State agencies, because these agencies are absolutely key to the growth of higher education opportunity in this country. Since student loans are essentially State programs, and with greater emphasis than ever before on State and local responsibilities for education, it is evident that the student loan market can only benefit from the presence of vigorous actors at both the Federal and State levels.

The market itself, as I have indicated, is an attractive one, but it does have an unmet need at the Federal level which might warrant additional congressional attention, and which this subcommittee may wish to address in view of its interest in encouraging student loans. I refer to the need for greater legislative continuity.

As you know, student loans are already extremely complex due to the involvement of numerous intermediaries and to considerable variegation among State regulations and requirements. The operational burdens involved in this complexity are to a certain extent unavoidable, although they are obviously more onerous for lenders which operate on a multistate level than for institutions lending within only one State. In addition, banking is a very narrow margin business. A successful bank makes less than 1 percent return on assets.

In other words, if it loses money on one loan it must make 100 similar ones just to break even. This is the major reason why bankers abhor uncertainty, the profit margins of the business are too thin to afford the luxury of playing it by ear. Under these circumstances any aggravation of existing market uncertainties provides a strong disincentive to doing business.

For this reason, frequent legislative change can play a major role in discouraging prospective lenders, especially when the high level of uncertainty created by such change requires resolution within tight timeframes dictated by a business' seasonal nature.

This has been the case with regard to student loans almost every year since 1965, and without taking issue with various substantive changes that have been legislated, I would say that the net result

of this heightened uncertainty is a message to prospective lenders not to enter the business.

With all due respect, this would appear to be quite the opposite of what Congress has intended, and I would therefore imagine that a plea for greater opportunity in legislation and regulation is appropriate.

Clearly, the need for student loans remains substantial and can be expected to increase further. It's a market to which we at this time intend to remain active, and as for Sallie Mae, we believe that both its fundamental mission and its performance against that basic mission represent positive factors in the market.

Thank you, Mr. Chairman.

Mr. SIMON. Thank you very much.

Finally, Mr. Hurley.

[Prepared statement of Geoffrey Hurley follows:]

PREPARED STATEMENT OF GEOFFREY K. HURLEY, ESQ., BROWN, WOOD, IVEY, MITCHELL & PETTY, ONE WORLD TRADE CENTER, NEW YORK, N.Y.

I appreciate having the opportunity to testify before this Committee today relating to the relationship between the Student Loan Marketing Association ["Sallie Mae"] and a statutory provision that establishes, in the case of the insolvency of any person, a priority in favor of the United States for debts owed by such person to the United States over other indebtedness of such person. I am a partner in the New York City law firm of Brown Wood, Ivey, Mitchell & Petty. In connection with Sallie Mae's underwritten public offerings of securities during 1982 and 1983, my firm acted as counsel to the syndicates of securities firms that purchased Sallie Mae's securities for resale to the investing public, and I have been the partner at Brown, Wood with primary responsibility for our participation in these financings.

In 1974, Sallie Mae sold through an underwritten public offering to eligible financial institutions and educational institutions under its enabling legislation an issue of its voting common stock. Subsequent to that stock offering, Sallie Mae raised the funds necessary to support its operations primarily from the sale of its debt obligations, which were guaranteed by the Secretary of Education or his predecessor, to the Federal Financing Bank [the "FFB"]. In March, 1981, Sallie Mae and the FFB entered into an agreement pursuant to which the FFB agreed to lend Sallie Mae up to $5 billion, inclusive of then outstanding borrowings, prior to September 30, 1982 and Sallie Mae agreed to cease utilizing the FFB as a funding source upon the earlier of the borrowing of $5 billion on September 30, 1982. On January 7, 1982, Sallie Mae borrowed from the FFB the last of the funds available to it under this agreement and, with $5 billion of FFB debt outstanding, its access to the FFB as a source of funding ended.

In anticipation of leaving the FFB and meeting its financing needs through non-guaranteed securities offerings in the public credit markets, Sallie Mae began, in May 1981, to issue its non-guaranteed short-term (i.e. a maturity of one year or less) Discount Notes to investors through a group of securities dealers. In February 1982, Sallie Mae sold in an underwritten public offering $250 million of its Floating Rate Notes, Series A, Due February 15, 1985. This was Sallie Mae's first public offering of non-guaranteed debt obligations. This financing was followed by the sale in March 1982 of another $200 million of Floating Rate Notes in an underwritten public offering and the sale in September 1982 of $100 million of fixed-rate notes. In March 1983, Sallie Mae sold 5 million shares of its Adjustable Rate Cumulative Preferred Stock, Series A. In addition to these underwritten public offerings, Sallie Mae has, since September, 1982, sold both fixed rate and floating rate debt obligations to the investing public through a syndicate of securities dealers.

At the time of Sallie Mae's initial public offering of non-guaranteed debt securities in February 1982 and in connection with each public offering since then, prospective underwriters of such securities have, in light of the large amount of Sallie Mae's outstanding indebtedness to the FFB, sought assurances that, in the event Sallie Mae should become insolvent or be liquidated or reorganized, the debt owing to the FFB would not be accorded priority over Sallie Mae's debt obligations sold to the public by virtue of Section 191 of Title 31 of the United States Code (which I understand has recently been re-codified as 31 U.S.C. § 3713). Section 191 (which I shall hereinafter refer to as the "Federal Priority Statute") provides that, when a

person who is indebted to the United States is insolvent, and certain acts are committed, the debts due to the United States shall first be satisfied. Section 191 does, however, provide that the priority established under such section soes not apply in a case under the Federal Bankruptcy Code. (11 U.S.C. § 101-151326). This exception was not of any assistance to Sallie Mae, since there was serious doubt as to whether Sallie Mae was eligible to be a "debtor" under the Federal Bankruptcy Code. To be a debtor under the Federal Bankruptcy Code, one must be a "person". (11 U.S.C. § 109(a)). A "person" is defined to expressly exclude a "governmental unit". (Id. at § 101(30)). The term "governmental unit" is, in turn, defined to include a "department, agency or instrumentality of the United States". (Id. at § 101(21)). Thus, if Sallie Mae were considered to be an "agency or instrumentality of the United States", it would not be eligible to be a debtor under either Chapter 7 of the Federal Bankruptcy Code relating to liquidations or Chapter 11 relating to reorganizations. If the liquidation or reorganization of Sallie Mae were not conducted under the Federal Bankruptcy Code, the Federal Priority Statute would be applicable. My firm and Milbank, Tweed, Hadley & McCloy, the law firm which acted as special counsel to Sallie Mae in connection with its underwritten public offerings, believed that, in light of Sallie Mae's status as a congressionally chartered corporation and the various attributes that it possesses under its enabling statute, it would be impossible to determine conclusively that Sallie Mae would not be considered by a court to be an instrumentality of the United States for purposes of the Federal Bankruptcy Code.

In 1981, the Congress amended Section 439(1) of Sallie Mae's enabling legislation, effective September 12, 1981, by adding the following senten

"For the purpose of the distribution of its property pursuant to Section 726 of Title 11, United States Code, the Association [Sallie Mae] shall be deemed a person within the meaning of such title."

This amendment clearly made Sallie Mae eligible to become a debtor in a voluntary or involuntary liquidation proceeding under Chapter 7 of the Federal Bankruptcy Code, in which proceeding the Federal Priority Statute would not be applicable. However, because the amendment referred explicitly only to Chapter 7 of the Federal Bankruptcy Code which governs liquidations and not to Chapter 11 of the Federal Bankruptcy Code which governs reorganizations, it is not clear that the amendment made Sallie Mae eligible to be a debtor in a reorganization proceeding under Chapter 11 of the Federal Bankruptcy Code. If Sallie Mae were not eligible to become a debtor under Chapter 11 of the Federal Bankruptcy Code, any reorganization proceeding could take the form of an equity receivership in which the Federal Priority Statute would be applicable. Moreover, making Sallie Mae an eligible debtor under the Federal Bankruptcy Code would not preclude Sallie Mae from seeking relief under state insolvency proceedings in which the Federal Priority Statute would be applicable.

Effective December 29, 1981, the Congress further amended Section 439(1) to make it explicit that the Federal Priority Statute would not be applicable to debt of Sallie Mae issued or incurred on or before September 30, 1982. This was accomplished by the following provision:

"The priority established in favor of the United States by Section 3466 of the Revised Statute (31 U.S.C. 191) shall not establish a priority over the indebtedness of the Association [Sallie Mae] issued or incurred on or before September 30, 1982."

The legislative history of this amendment states that it was intended to "clarify the status of creditors of the Student Loan Marketing Association (Sallie Mae) in the event of a financial reorganization short of complete bankruptcy conducted for the benefit of creditors," by providing that "indebtedness of Sallie Mae to the United States shall, in all cases, have equal priority with other indebtedness of Sallie Mae, regardless of maturity, so long as such other indebtedness was issued or incurred on or before September 30, 1982." In enacting this amendment, the Congress explicitly recognized "[d]ue to Sallie Mae's extensive borrowings from the Federal Financing Bank, the existence of a federal priority for such borrowings effectively precludes Sallie Mae from selling its debt obligations in the public capital markets." (H.R. Rep. No. 97-386 (Conference Report), 97th Cong., 1st Sess. 40 (1981) (Joint Explanatory Statement of the Committee of Conference)). This provision has subsequently been amended to extend its applicability to indebtedness of Sallie Mae issued or incurred on or before September 30, 1984.

By virtue of the December 29, 1981 amendment to Section 439(1) of the Act, Brown, Wood was able, in connection with each underwritten public offering of Sallie Mae's debt obligations, to render an opinion to the underwriters of such securities that:

"The priority granted to the United States by 31 U.S.C. § 191 in the case of the insolvency of certain persons indebted to the United States does not establish a pri-

ority in favor of the United States with respect to indebtedness of Sallie Mae to the United States over other indebtedness of Sallie Mae, including the Notes, issued or incurred on or before September 30, 1982."

This opinion was a condition to the purchase by the underwriters of Sallie Mae's notes and could not have been rendered by us if the December 29, 1981 amendment to Section 439(1) had not been enacted. The extension of the applicability of this amendment to Sallie Mae's debt obligations issued or incurred on or before September 30, 1984 would permit us to render a similar opinion for debt financings that were consummated on or prior to such date.

If the Congress does not explicitly extend the waiver of the Federal Priority Statute to indebtedness of Sallie Mae issued after September 30, 1984, I believe that Sallie Mae's debt obligations issued after such date would be viewed as subject to the Federal Priority Statute except in liquidation proceedings under Chapter 7 of the Federal Bankruptcy Code and, therefore, for practical purposes would be regarded as subordinated to Sallie Mae's indebtedness to the FFB. In addition, Sallie Mae would be in the awkward position of having its pre-September 30, 1984 publicly held debt not subordinate and its post-September 30, 1984 debt subordinate to the indebtedness to the FFB. Certainly, representatives of the securities firms that sell Sallie Mae's debt obligations to the investing public are more qualified than I to comment on the effect that such a situation would have upon their ability to sell Sallie Mae's debt obligations and the pricing of such securities. I do, however, believe that potential investors would regard as a significant negative the fact that, in the event of the insolvency of Sallie Mae, $5 billion of indebtedness to the FFB would be senior to the debt obligations held by them and that outstanding debt obligations sold to the public on or prior to September 30, 1984 would not be subject to such a priority.

STATEMENT OF GEOFFREY HURLEY, OF BROWN, WOOD, IVEY, MITCHELL & PETTY

Mr. HURLEY. Thank you, Mr. Chairman.

I appreciate having the opportunity to testify before this subcommittee today relating to the relationship between Sallie Mae and a statutory provision that establishes in the case of the insolvency of any person, priority in favor of the United States for debts owed by such person to the United States.

I am a partner in the New York City law firm of Brown, Wood, Ivey, Mitchell & Petty. In connection with Sallie Mae's underwritten public offerings of securities during 1982 and 1983, my firm acted as counsel to the syndicates of securities firms that purchased Sallie Mae's securities for resale to the investing public, and I have been the partner at Brown, Wood with primary responsibility for our participation in these financings.

As you are aware, in 1974, Sallie Mae sold to an underwritten public offering to eligible financial institutions and educational institutions under its enabling legislation an issue of its voting common stock. As Mr. Cavanaugh has testified this morning, subsequent to that offering, Sallie Mae primarily raised the funds necessary to support its operations from the sale of its debt obligations, which were guaranteed by the Secretary of Education or his predecessor to the Federal Financing Bank.

In March 1981, Sallie Mae and the Financing Bank entered into an agreement pursuant to which the Financing Bank agreed to lend Sallie Mae up to $5 billion prior to September 1982 and Sallie Mae agreed to cease utilizing the Financing Bank upon the earlier of borrowing $5 billion or September 30, 1982.

On January 7, 1982, Sallie Mae borrowed from the Financing Bank the last of the funds available to it under this agreement and at that time its access to the Financing Bank as a source of funding ended.

In anticipation of leaving the Financing Bank and meeting its financing needs through nonguaranteed securities offerings in the public credit markets, Sallie Mae began in May, 1981 to issue its nonguaranteed short-term discount notes to investors through a group of securities dealers.

In February 1982, Sallie Mae sold in an underwritten public offering $250 million floating rate notes. This was Sallie Mae's first public offering of nonguaranteed debt obligations. This financing was followed by the sale in March 1982 of another $200 billion of floating rate notes and in September 1982 of $100 million of fixed-rate notes. In March 1983, Sallie Mae sold 5 million shares of its adjustable rate preferred stock. In addition to these underwritten offerings, Sallie Mae has, since September, 1982, sold both fixed-rate and floating-rate debt obligations to the investing public.

At the time of Sallie Mae's initial public offering of February 1982, and in connection with each public offering since then, prospective underwriters of such securities have, in light of the large amount of Sallie Mae's outstanding indebtedness to the Financing Bank, sought assurances that, in the event Sallie Mae should become insolvent or be liquidated or reorganized, the debt owing to the Financing Bank would not be accorded priority over Sallie Mae's debt obligations sold to the public by virtue of section 191 of title 31 of the United States Code.

Section 191 provides that when a person who is indebted to the United States is insolvent, and certain acts are committed, the debts due to the United States shall first be satisfied.

Section 191 does, however, provide that the priority established under that section does not apply in a case under the Federal Bankruptcy Code. This exception was not of any assistance to Sallie Mae since there was serious doubt as to whether Sallie Mae was eligible to be a debtor under the Code.

It is significant to recognize that private corporations which do business with the U. S. Government and are, therefore, in a position to incur indebtedness or liabilities to the United States would, absent unusual circumstances, be eligible to be debtors under the Code.

To be a debtor, one must be a person. A person is defined to include an individual, a partnership or a corporation, but expressly excludes a governmental unit. The term "governmental unit" is defined to include a department, agency or instrumentality of the United States. Thus if Sallie Mae were considered to be an agency or instrumentality of the United States, it would not be eligible to be a debtor under either chapter 7 of the Bankruptcy Code, relating to liquidations, or chapter 11 relating to reorganization.

If the liquidation or reorganization of Sallie Mae were not conducted under the Federal Bankruptcy Code, the Federal Priority Statute would be applicable. My firm and Milbank, Tweed, Hadley & McCloy, the law firm which acted as special counsel to Sallie Mae in connection with its underwritten public offerings, believed that in light of Sallie Mae's status as a congressionally chartered corporation and the various attributes that it possesses under its enabling statute, it would be impossible to determine conclusively that Sallie Mae would not be considered by a court to be an instru-

mentality of the United States for purposes of the Federal Bankruptcy Code.

In 1981, the Congress amended section 439(l) of Sallie Mae's enabling legislation. That amendment clearly made Sallie Mae eligible to become a debtor in a voluntary or involuntary liquidation under chapter 7, in which proceeding, the Federal Priority Statute would not be applicable.

However, because the amendment referred explicitly only to chapter 7, which governs liquidation, and not to chapter 11, which governs reorganization, it is not clear that the amendment made Sallie Mae eligible to be a debtor in a reorganization proceeding under chapter 11.

If Sallie Mae were not eligible to become a debtor under chapter 11, any reorganization proceeding could take the form of an equity receivership in which the Federal Priority Statute would be applicable. Moreover, making Sallie Mae an eligible debtor under the Federal Bankruptcy Code would not preclude Sallie Mae from seeking relief under State solvency proceedings in which the Federal Priority Statute would be applicable.

Effective December 29, 1981, the Congress further amended section 439(l) to make it explicit that the Federal Priority Statute would not be applicable to debt of Sallie Mae issued or incurred on or before September 30, 1982. This provision has subsequently been amended to extend its applicability to indebtedness of Sallie Mae issued or incurred on or before September 30, 1984.

By virtue of the 1981 amendment, my firm was able in connection with each underwritten public offering of Sallie Mae's debt obligation, to render an opinion to the underwriters of such securities to the effect that the Federal Priority Statute was not applicable to indebtedness of Sallie Mae issued on or before September 30, 1982.

This opinion on the condition to the purchase by the underwriters of Sallie Mae's notes and could not have been rendered by us if the December 29, 1981, had not been enacted. The extension of the applicability of this amendment would permit us to render a similar opinion for debt financings that were consummated on or prior to such date.

If the Congress does not explicitly extend the waiver of the Federal Priority Statute to indebtedness to Sallie Mae issued after September 30, 1984, I believe that Sallie Mae's debt obligations issued after such date would be viewed as subject to the Federal Priority Statute except in liquidation proceedings under chapter 7 of the Code, and therefore, for practical purposes, would be regarded by investors as subordinated to Sallie Mae's indebtedness to the Federal Financing Bank.

In addition, Sallie Mae would be in the awkward position of having its pre-September 30, 1984, publicly-held debt not subordinate and its post-September 30, 1984 subordinate to the Federal Financing Bank indebtedness.

Mr. Solomon has testified as to the cost of Sallie Mae, of having to market its debt obligations under these circumstances because of investors' negative perceptions of the situation in which, in the event of the insolvency of Sallie Mae, $5 billion of indebtedness to the Federal Financing Bank would be senior to the debt obligations held by them.

Moreover, I believe that the procedure of reviewing the statutory waiver of the Federal Priority Statute every few years creates uncertainties for both Sallie Mae and the financial marketplace. Since Sallie Mae and investors need to be concerned as to whether a decision by Congress not to the extent the waiver will have an adverse impact on Sallie Mae's ability to refinance its outstanding indebtedness.

In addition, Sallie Mae must, in developing a financing plan for a particular year, time its public borrowings around the expiration date of the statutory waiver provision and solely according to its financing needs and conditions existing in the public credit markets.

That concludes my testimony.

Thank you, Mr. Chairman.

Mr. SIMON. Thank you, Mr. Hurley.

I gather your belief is that the sooner we can act on that September 30, 1984, deadline the better?

Mr. HURLEY. That's correct.

Mr. SIMON. Let me ask, Mr. Hammer, since Chase Manhattan was brought up, your formal statement says you are the second largest lender. My impression had been that you are the largest. You mean second to Sallie Mae or do you mean second to some other——

Mr. HAMMER. Citibank and ourselves are very close, sir. It depends on any 1 year who originates the most and how much we participate in the secondary market.

Mr. SIMON. All right.

I notice in your oral remarks you said "one of the largest". Does that mean——

Mr. HAMMER. I didn't look at the last date of that, but it's big. After Citibank and ourselves, I think the next one is a whole point lower, which would be another $100 million lower.

Mr. SIMON. OK.

You heard the testimony of Mr. Clohan here. This is a problem. I am not sure that it is a problem that we can be addressing immediately, but it's one we ought to be taking a look at.

What do we do to encourage Chase Manhattan? Obviously, you have to have some kind of an incentive for handling loans that are going to be more work, since they are going to offer more problems than other loans, simply because of the nature of the students involved here. What can be done?

Mr. HAMMER. One minor correction there, sir. It's not the nature of the student, it's the size of the loan. That's the whole problem.

Mr. SIMON. Except—if I may just modify that.

Mr. HAMMER. Yes.

Mr. SIMON. Because you are dealing with students who generally are from lower income families.

Mr. HAMMER. That really has no bearing on the matter. We basically are looking at the economics of the unit and if you are talking about a $500 unit, than our processing costs as a percent are much higher and it wouldn't make any difference if it was one of our most valued customers who wanted a $500 loan or someone we never saw before, it's the size of the loan that makes the difference.

Mr. SIMON. Except that if David Rockefeller, Jr., wants to borrow $500, the chances are a little greater that you are going to get that repaid than somebody who is unemployed——

Mr. HAMMER. But the difference here is that, given that is a guaranteed program, the creditworthiness of the borrower is not relevant to our consideration.

Mr. SIMON. OK.

Mr. HAMMER. See, we call it a student loan business, but really it's a processing business. The only credit considerations that are relevant here are the creditworthiness of the guarantee agency in the State.

Mr. SIMON. I follow you.

Mr. HAMMER. That's why it is an important distinction.

Well, the basic problem is as Mr. Clohan pointed out. The small units are not economical to process. I don't like it any more than you do. We changed our policy. The policy that was indicated we put into effect after the major change in the student loan legislation which occurred in 1981 so that we absolutely got inundated by applications with everyone trying to get in under the wire and the processing systems were unable to handle it.

Ourselves, as a huge lender, and many others around the country absolutely got into a situation where we fell behind and had huge backlogs and we just had to do something to control volume while we put new systems into place. Those systems themselves change almost annually, depending upon what new legislation is coming forth. That last couple of years have not been so bad, incidentally, but up to that time, you couldn't get a system to reach equilibrium because by the time you would start to debug it, there would be a new legislative change and it would have to be in place immediately because in the fall is when the new applications come in.

We were in a situation, and I know others were, too, where the reputation of the bank starts to suffer and for ourselves, given the kind of reputation we feel we deservedly enjoy around the world, the question was, "Do we stay in the business?" It's just not worth, for the narrow margin that one earns on the business, this negative that comes along with not being able to process efficiently.

In those three areas, at the stage of the game in our own experience, we have now cleaned up with a totally new—we have had 2 years now to operate without major legislative change—the originations area—and consequently, we have now relaxed our policy. We are now down to a minimum loan of $1,000—that's since that survey Mr. Clohan mentioned was taken—but it's still only to 2-year colleges, because we are looking for an averaged-sized loan that is higher. The reason for that, of course, is that when we do sell in a secondary market, for one reason or another, we do have to sell at a discount. That, of course, comes right off the bottom line and in a business which is right on the margin anyhow, you just can't afford it. So one of those three options that was suggested would make sense.

For ourselves, it really comes into play when we make the sale and that would be dependent upon the price we are able to get from Sallie Mae.

The suggestion, I believe, that was made was that Sallie Mae be given some kind of special allowance at the time it makes the purchase.

I guess I would not support that, although it's not a bad idea, but as a uniform only solution because, while Sallie Mae has played an excellent role in the secondary market, I would like to see something done so that there is more active participation in the secondary market rather than give Sallie Mae a particular unilateral hand here.

Obviously, the more competition we have of people trying to buy our loans, maybe the better rate we can ourselves exact, and I think that would be consistent with Mr. McCabe's and Mr. Fox's comments about themselves not wanting a monopoly.

The other alternative, of course, would be to give a special allowance for the small loan to the lender when he originates it. The problem with that one, of course, is that it could be that next year or the year after that same student comes in for another loan, maybe goes to a full-time school and then now you have the size loan that when you consolidate the two, which is economic, so we would have gotten an extra payment, which would really not be justified. To try to put systems in place to try to keep track of these, that's the kind of costs which you are trying to avoid.

But something along that nature would really have to be done in order to induce a lender to participate in the program and I would be perfectly willing to have the people that run my program, where we do have these operating models available, to sit down with your staff and try to work out a sensible approach.

Mr. SIMON. I thank you. We are going to probably be back in touch with you on that.

Mr. HAMMER. Certainly.

Mr. SIMON. Mr. Solomon, just one general question. Your statement was a very laudatory one of Sallie Mae. Do you see any weaknesses in the structure?

Mr. SOLOMON. Well, I don't see too many weaknesses in the financial structure. Sallie Mae has moved to reduce its leverage by a recent preferred issue, it has built up its equity a little, it has a lot of room and a leverage area now, and it has been very creative in matching its liabilities and assets, which is the key to making sure it doesn't get into a negative position.

I think they have been unusually innovative in the market and, as I said, they are basically the only institution that has made the transition from the FFB to the public market. I think they have been very skillful at it. I don't really see any real major problems ahead for them financially. I think they can deal with the volatility of the markets. They will always be under greater strain at higher rates than lower rates, but I think they are in pretty good shape.

Mr. SIMON. Thank you.

Mr. Coleman.

Mr. COLEMAN. No questions, Mr. Chairman.

Mr. SIMON. We thank the three of you very much, not only for your testimony here but for what you are contributing through and with Sallie Mae for the Nation.

The hearing stands adjourned.

[Whereupon, at 11:35 a.m., the subcommittee was adjourned.]